

Muhammad al-Bashir Muhammad al-Amine

Risk Management
in Islamic Finance

*An Analysis of Derivatives Instruments
in Commodity Markets*

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Risk Management in Islamic Finance

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Risk Management in Islamic Finance

An Analysis of Derivatives Instruments
in Commodity Markets

By

Muhammad al-Bashir Muhammad al-Amine



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CONTENTS

List of Tables.....	ix
List of Statutes	ix
List of Cases.....	ix
Acknowledgments.....	xi
List of Contemporary Scholars.....	xiii
The Islamic Fiqh Academies	xix
Transliteration.....	xxi
Chapter One Introduction	1
Background of the Research	1
Objectives of the Research	7
Research Methodology	8
Scope and Limitations of the Study	10
Outline of Chapters	12
Distinctive Features of the Research	14
Literature Review	15
Forward and Futures Contracts	15
Options Contracts	35
Chapter Two The Forward Commodities Market	44
Economic Benefits of the Forward Contract	45
<i>Istiṣnā'</i> and the Forward Contract	61
<i>Ibtidā' Al-Dayn Bi Al-Dayn</i> and the Forward Contract	63
<i>Bay' Al-Ṣifah</i> and the Forward Contract	65
Nonexistence of the Subject Matter and the Forward Contract	67
Chapter Three Is it Permissible to Exchange Gold with Paper Money on Forward Basis?	72
Historical Sketch of the World Monetary System	72
Critical Analysis of Several Fatwās on Gold Trading	75
The 'Illah behind Trading Gold unless Its Hand to Hand	84
The Effect of the 'Illah in Gold to Its Trade on a Forward Basis	87

Chapter Four	The Forward Market for Currencies	94
	Basic Rules of Currency Exchange and Paper Money	94
	Mutual Promise in Currency Exchange	103
	Mutual Loan and Currency Risk Management	109
	Currency Basket and Risk Management	110
	Managing Price Fluctuation through Deposit	111
	Cooperative Funds and Currency Risk Management	111

THE FUTURES MARKET

Chapter Five	Concept, Scope of Futures Contracts and Speculation	121
	Concept of Futures Contracts	121
	Characteristics of a Successful Futures Market	123
	Futures Contracts and Forward Contracts	124
	A Brief History of the Commodity Market	130
	Scope of the Futures Market	133
	Economic Benefits of Futures Contracts	134
	The Clearinghouse and the Futures Market	139
	Hedging and the Futures Market	141
	Speculation and the Futures Market	143
	Speculation and Financial Crises	150
	Arbitrage and Speculation	155
	Margin Trading and Speculation	157
Chapter Six	Sale Prior to Taking Possession, Sale of Debt and Futures Contract	159
	Juristic Debate over Sale prior to Taking Possession	159
	The Meaning of <i>Tā'ām</i>	164
	<i>Salam</i> and the Futures Contracts	165
	Parallel <i>Salam</i> and the Futures Market	167
Chapter Seven	Futures Market Regulation	177
	Intermediaries in the Futures and Options Market	177
	The Fidelity Fund	180
	Futures Market Regulation	181
	Trading Offences Under the Futures Industry Act and Islamic Law	186

THE OPTIONS MARKET

Chapter Eight	Concept and Scope	195
	Concept of Options	195
	Definition	196
	Economic Benefits of Options	198
	American and European Options	203
	Types of Options	204
	Exchange Traded and Over-The-Counter Islamic Options	206
	A Brief History of Options Trading	207
	Scope of Options	208
	Options and Gambling	210
Chapter Nine	<i>Khiyār Al-Shart</i> , Risk Management and	
	Options	222
	Concept of <i>Khiyār Al-Shart</i>	223
	The Terms of <i>Khiyār Al-Shart</i>	224
	Ownership of Commodity During the Period of <i>Khiyār</i> and	
	Libiality for Damage	226
	Managing Price Risk with <i>Khiyār Al-Shart</i>	228
	<i>Khiyār Al-Naqd</i>	234
Chapter Ten	‘ <i>Arbūn</i> Risk Management and Options	237
	The Legal Status of <i>Bay’ Al-‘Arbūn</i>	241
	‘ <i>Arbūn</i> in Currency Exchange or <i>ṣarf</i>	242
	‘ <i>Arbūn</i> in Commodities and Services	242
	‘ <i>Arbūn</i> in Shares Trading	244
	‘ <i>Arbūn</i> in <i>Murābahah</i>	245
	‘ <i>Arbūn</i> in <i>Salam</i>	250
	‘ <i>Arbūn</i> in ‘ <i>Istiṣnā’</i>	251
	‘ <i>Arbūn</i> as the Islamic Alternative to Options	252
	‘ <i>Arbūn</i> as an Alternative to Call Option	253
	‘ <i>Arbūn</i> as an Alternative to Put Option	254
	Does Options Trading Involve the Combination of Two	
	Contracts in One Transaction?	264

Chapter Eleven The Sale of Pure Rights and the Legality of Options	266
Concept of <i>Māl</i> or Property	273
<i>Haqq Al-Nuzūl 'An Al-Wazā'if</i> and the Sale of Rights	276
<i>Huqūq Al-Irtifāq</i> and the Sale of Rights	278
<i>Badal Al-Khulu</i> and the Sale of Rights	280
Sale and Exchange of the Right of Precedence	282
Intellectual Property and the Sale of Right	284
Right to Option in <i>Khiyār Al-Sharṭ</i> and <i>Right of Shuf'ah</i> or Pre-Emption as Property Rights	287
Sale and Exchange of the Right to Option in <i>Khiyār</i> <i>Al-Sharṭ</i> and the Right to Pre-Emption or <i>Shuf'ah</i>	290
Exchange of Right to Bargain for Purchase of Commodity ...	294
Sale of a Right By a Wife To Have Her Husband With Her ...	295
Earning an Exchange For Waiving the Right To <i>Hadānah</i>	295
Earning an Exchange For Waiving a Right	296
Conclusion	299
Glossary of Arabic Terms	309
Bibliography	319
Index	329
Abstract	333
ملخص البحث	338

LIST OF TABLES

1.1	Opinion of Major Schools on the Conditions of <i>Salam</i>	53
2.2	Comparison Between Futures and Forward Contracts	126

LIST OF STATUTES

<i>Company Act</i>	187
Futures Industry Act	11; 12; 18; 159; 161; 162; 187; 240; 241; 242; 143; 245; 247; 252; 254; 258
Securities Industry Act	11; 12; 247

LIST OF CASES

<i>Sydney Futures Exchange Ltd v. Australian Stock Exchange Ltd</i> (1995) 13 ACLC 369	121
<i>Richardson Greenshields of Canada(Pacific) Ltd v. Keug Chak-kiu and Hong Kong Futures exchange Ltd</i> (1989) 1 HKLR 476	210

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THE ISLAMIC FIQH ACADEMIES

Islamic Fiqh Academy (*Majma' al-Fiqh al-Islami*) is an affiliated institution of the Organization of Islamic Conference (OIC). It was established by Resolution No.8/3-C, (I.S.) adopted by the Third Islamic Summit Conference, held in Makkah Al-Mukarramah and Taif (Saudi Arabia) called for the establishment of an Islamic Fiqh Academy. The Headquarters of the Academy is located in Jeddah, Kingdom of Saudi Arabia. Almost all 57 Muslim countries are represented in the Academy.

The objectives of the Academy are:

1. To achieve the theoretical and practical unity of the Islamic Ummah by striving to have Man conform his conduct to the principles of the Islamic *shari'ah* at the individual, social as well as international levels.
2. To strengthen the link of the Muslim community with the Islamic faith.
3. To draw inspiration from the Islamic *shari'ah*, to study contemporary problems from the *shari'ah* point of view and to try to find the solutions in conformity with the *shari'ah* through an authentic interpretation of its content.

The Islamic Fiqh Academy (*al-Majma' al-Fiqhi al-Islami-Mecca*) is an academic body with a legal personality belonging to the Muslim World League. It was established based on a decree of the Constituent Council in 1398 Hejriah. It consists of an assorted group of Islamic Jurists from around the Muslim world.

The Fiqh Council examines new issues facing Muslims, in order to show the rulings of *Al-Shari'ah* deduced from the Qur'an and the Sunnah. The main objective of the Academy are:

1. To present appropriate solutions non opposing to Islamic Laws (*shari'ah*) for contemporary problems of the Muslims
2. To project the supremacy of Islamic Laws over man made laws
3. To spread and disseminate the Islamic Fiqh
4. To show all related laws of *shari'ah* to those Muslims who ask

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), is a based in Bahrain organization. It is a self-regulatory standard-setting body that issues accounting, auditing, governance, ethics and *shari'ah* standards for Islamic financial institutions. To date, AAOIFI has issued more 50 standards and statements, which are mandatory in Bahrain, Sudan and Jordan, and form the basis for regulatory standards in several other countries, including Qatar and Saudi Arabia. The standards are also used as reference by Islamic financial institutions around the world.

The Council of Great Scholars is a national Saudi body established in 1971 by a Royal Decree. It is composed of *shari'ah* scholars from Saudi Arabia appointed by royal decree. The Council gives opinion based on the interpretation of the *shari'ah* covering different aspects of life as referred to the council by the Kingdom authorities.

TRANSLITERATION

Consonants

ب	b	ط	t
ت	t	ظ	z
ث	th	ع	'
ج	j	غ	gh
ح	h	ف	f
خ	kh	ق	q
د	d	ك	k
ذ	dh	ل	l
ر	r	م	m
ز	z	ن	n
س	s	ه	h
ش	sh	و	w
ص	ṣ	ء	'
ض	ḍ	ي	y

Vowels and Diphthongs

ا	A	آ	ā	آ	ā	آ in pause form	ah
إ	i	إي	ī	آي	ay	آ in construct form	at
أ	u	أو	ū	أو	aw		

CHAPTER ONE

INTRODUCTION

Background of the Research

The mastery of risk is a stupendous challenge. It may be regarded as the distinguishing feature of modern times. Someone has rightly remarked that the elimination of risk has replaced the elimination of scarcity as a major preoccupation.

There are several risks which need to be managed by financial institutions, be they Islamic or conventional. They include, among others, market risk, interest rate risk, credit risk, liquidity risk, operational risk, litigation risk, regulatory risk, and foreign exchange risk. The nature of some of these risks is briefly discussed below:

Market risk is the risk originating in instruments and assets traded in well-defined markets. Market risks can result from macro and micro sources. Systematic market risk results from overall movement of prices and policies in the economy. The unsystematic market risk arises when the price of the specific asset or instrument changes due to events linked to the instrument or asset. Volatility of prices in various markets gives rise to different kinds of market risks. Thus market risk includes equity price risk, interest rate risk, currency risk, and commodity price risk.

Interest rate risk is the exposure of a bank's financial condition to movements in interest rates. In Islamic financial institutions, due to the prohibition against charging and paying interest, rates are not directly affected by risk. However, they are indirectly affected by this risk in their bid to determine their return. Islamic financial institutions use the London Inter Bank borrowing rate (LIBOR) as a benchmark in their transactions. Thus, the effect of interest rates can be transmitted to Islamic banks indirectly through this benchmark. In case of a change in the LIBOR, the Islamic banks could face this risk in the sense of their paying more profit to future depositors as compared to receiving less income from the users of long-term funds.

Credit risk is the risk that a counterparty will fail to meet its obligations in a timely manner and fully in accordance with the agreed upon terms. This risk can occur in the banking and trading books of the bank.

Liquidity risk arises due to insufficient liquidity for normal operating requirements, thus reducing the ability of banks to meet its liabilities when they fall due. This risk may result from either difficulties in obtaining cash at reasonable cost from borrowing (funding or financing liquidity risk) or the sale of assets (asset liquidity risk). One aspect of asset-liability management in the banking business is to minimize the liquidity risk. While funding risk can be controlled by proper planning of cash-flow needs and seeking newer sources of funds to finance cash shortfalls, the asset liquidity risk can be mitigated by diversification of assets and setting limits on certain illiquid products.

Operational risk may arise from human and technical errors or accidents. It is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology or from external events. While human risk may arise due to incompetence and fraud, technology risk may result from telecommunications system and program failure. Process risk may occur due to various reasons, including errors in model specifications, inaccurate transaction execution, and violating operational control limits. Due to problems arising from inaccurate processing, record keeping, system failures, compliance with regulations, etc., there is a possibility that operating costs might be different from what is expected and therefore affect net income adversely. Given the newness of Islamic banks, operational risk in terms of human risk can be sometimes acute in these institutions. Operational risk in this respect particularly arises as the bank may not have enough professional personnel to conduct Islamic financial operations. Moreover, given the nature of business, the computer software available in the market for conventional banks may not be appropriate for Islamic banks.

Legal risks relate to risks of unenforceability of financial contracts. This relates to statutes, legislation, and regulations that affect the fulfillment of contracts and transactions. This risk can be external in nature, like regulations affecting certain kinds of business activities or internal matters related to a bank's management or employees, like fraud, violations of laws and regulations, etc. Legal risks can be considered as a type of operational risk. Regulatory risk arises from changes in the regulatory framework of a country. Given the different nature of their financial contracts, Islamic banks face risk related to their documentation and enforcement. As there are no standard forms of contracts for various financial instruments, Islamic banks prepare these contracts according to the advice of their respective Shariah Board and the needs and concerns of local laws. Lack of standardized contracts and the absence

of a litigation system to enforce contracts by counterparty increase the legal risks associated with Islamic financial agreements.¹

Thus, risk is an ever-present factor, especially in business, but industrialization brought risks previously unknown in trade and agriculture. Industrial production often involves long periods of time, and the longer the period of production, the greater the uncertainty. The scope of the market has expanded to cover the entire globe, introducing new kinds of risk.²

In Islamic banking, the management of risk becomes more challenging due to its peculiar risk characteristics and the requirement for compliance to Shariah principles. While the Basel II initiatives on the identification of credit, market, and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the Islamic financial transactions. The risk management infrastructure in Islamic financial institutions needs to identify, unbundle, measure, control, and monitor all the specific risks in the Islamic financial transactions and instruments. This is to ensure that the systems and controls will be effective in the quantification and management of the risks arising from the operations.

An important aspect of risk management is the need for the Islamic banking industry to develop a derivatives market. In the current, increasingly uncertain, global financial environment, investors need to be in a position to mitigate and manage these emerging new risks. Islamic banking institutions, in particular, have, to a large extent, long-term assets, which include long-term Islamic housing mortgages and Islamic financial instruments that are funded by short-term deposits, thus giving rise to a maturity mismatch between the assets and liabilities. There is, therefore, a need for the development of a broader range of Islamic financial market instruments to provide the industry with effective risk mitigating instruments.³

¹ For more elaboration see Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry*, Occasional Paper no. 5, Islamic Research and Training Institute, Islamic Development Bank, 2001.

² Mohammad Nejatullah Siddiqi, "Islamic Banking and Finance," a lecture delivered at UCLA International Institute in a 2001 seminar for the business community.

³ Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz, "Governor's Keynote Address" at The 2nd International Conference On Islamic Banking: Risk Management, Regulation and Supervision—"Building a Robust Islamic Financial System," jointly organized by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and

It is important to distinguish between gambling, which is not permissible under Islamic law and must be avoided, along with other kinds of risk-taking. In the words of Irving Fisher, a gambler seeks and takes unnecessary risks. Such is the nature of games of chance. But life is full of risky situations that cannot be avoided. Business especially involves risk because the production of wealth involves the future, and it is impossible to have full and certain information regarding the future. People find mutually advantageous ways to face these uncertainties.

The economies of many Muslim countries rely to a great extent on raw materials and commodities. The production, investment, and pricing of these commodities are largely affected by the use of derivatives for risk management and trading in the international market. Questions normally arise regarding the Islamic position in the use of these instruments.

Derivatives markets deal in almost all the basic worldwide commodities, such as corn, wheat, cotton, crude oil, heating oil, gasoline, cocoa, palm oil, timber, rubber, aluminum copper, zinc, nickel, tin, coffee, sugar, etc. Hence, almost everybody feels the impact of these markets.

If we take oil, for instance, one of the world's most important commodities, without which it is impossible to conduct world commerce, its price is generally determined by the use of oil derivatives transactions.

Derivatives instruments largely evolved in a non-Islamic environment; thus, they are loaded with values which may not be totally in compliance with Islamic principles. Therefore, there is a need for a systematic analysis of these tools of price determination as well as risk management and hedging devices from an Islamic perspective.

More importantly, the availability of excess liquidity in many Islamic financial institutions, which require viable and permissible channels for investment, makes the study of these new tools of financial engineering in the international commodities markets a timely undertaking. Many questions arise regarding the evaluation of their compliance or disharmony with Islamic principles and the possibilities for new avenues of investment for Islamic financial institutions.

Furthermore, the widely held opinion that derivative instruments do not comply with *shari'ah* regulations whether due to *ribā* (interest), gambling or other illegal activities, may not be entirely accurate in regard

the Islamic Financial Services Board (IFSB). Le Meridien Hotel, Kuala Lumpur, 7 February 2006.

to at least certain forms of derivatives. Yet, the prevalence of this negative attitude has hindered the Islamic institutions from venturing into areas of investment that are open to conventional financial institutions. Therefore, it is important to address and analyze the available alternative avenues of investment so that Islamic financial institutions do not find themselves in a disadvantageous position.

A series of studies on the subject have been conducted by certain Islamic institutions such as *Majma' al-Fiqh al-Islami* (Islamic Fiqh Academy based in Jeddah), *al-Majma' al-Fiqh al-Islami* (Islamic Fiqh Academy based in Mecca), and by individual Muslim jurists. However, despite the welcome scholarly effort made so far, there are issues which still call for a systematic study and evaluation of the existing works and to address the shortcomings of some of these studies and the generalizations of others.

The present study will focus and elaborate on those issues which have not been well elaborated by previous works or which have been excluded from discussion despite their fundamental importance in understanding the issue of futures trading and derivatives.

The forward contract plays a pivotal role in the modern financial markets and serves as the basic building block for more advanced and sophisticated financial instruments. It is one of the most commonly used contracts in export–import trading, especially in essential commodities. It is also an important tool in risk management and business planning. However, in its actual form the majority of Muslim scholars declared it not permissible because it involves the prohibited sale of *bay' al-kali' bi al-kali'* (the sale of debt for debt) and the sale of nonexistent entities. The present study will explore these principles and look at their application to the conventional forward contract. It also draws an analogy between the conventional forward contract and similar contracts in Islamic law, such as *salam* (A sale contract to purchase an underlying asset at a predetermined future date but at a price paid on spot), *istisna'* (A contract whereby a manufacturer agrees to produce and deliver a well-described good at a given price on a given date in the future) and *bay' ala al-shifa* (sale by description).

Trading gold on a forward basis is a sensitive and controversial issue. The majority of scholars held that the *'illah* (effective cause, *ratio legis*) behind prohibiting the exchange of gold on a deferred basis is because gold and silver are currencies (*athman*) and, therefore, should not be exchanged unless the exchange is hand to hand. It is maintained that the prophetic injunctions not to trade gold and silver on a deferred basis

should be upheld whether gold and silver lose their characteristic of being *thaman* or not as they are money by creation. However, it is also argued by others that if gold and silver lose these characteristics, they would be a kind of commodity and could therefore be exchanged on a deferred basis. Thus, there is a need to analyze the different opinions advanced and look at their relevance to gold trading on a forward basis.

The forward currencies market is a very important mechanism in managing price risk. However, it is commonly agreed upon among Muslim scholars that trading currencies on a forward basis is illegal and it contravenes the rules of *ṣarf* (currency exchange) in Islamic law. Several alternatives have been suggested and there is a need to assess the *sharī'ah*' basis of these proposals.

Although the forward contracts have been able to overcome some of the problems associated with risk management, especially price risk and better planning of business, they are still inadequate to meet current business needs in some respects. Thus, the futures contract was introduced in the modern financial system in order to overcome these problems. A futures contract is basically a standardized forward contract with regard to the contract size, maturity, quality, place of delivery and the characteristic of being traded in an organized market. However, the futures contract might contravene the principle of not selling prior to taking possession and that of the sale of debt for debt. The present study will elaborate on the legal aspects of these two principles and try to find out how they could affect the legality of the futures contract. Moreover, the study will address the relation, if any, between the futures contract and speculation.

The futures contracts have been able to overcome some of the problems of the forward contract associated with risk, especially price risk and better planning of business, but they are still inadequate in some respects. The futures contracts are associated with certain problems, such as the possibility of exposure to subsequent price movement or their unsuitability for the management of contingent liabilities and contingent claims. Thus, a new tool of risk management is needed and the options contracts have been introduced due to their potential for managing such risks. The present study will examine the legality of options trading from an Islamic point of view by expounding on their concept, economic benefits, types, and scope.

Khiyār al-shart (the option to rescind a sales contract based on condition) and its variant *khiyār al-naqd* (the right of either of the parties to confirm the contract or to cancel it by means of the payment of the

price) seem to be the first alternative to conventional options from an Islamic point of view. This study will address the legal basis of these two contracts, the terms of *khiyār*, ownership of the commodity during the period of *khiyār*, liability for damage during this period and how *khiyār al-sharṭ* and *khiyār al-naqd* can be devised as tools to manage risk in *murābahah* (Sale at a specified profit margin, *ijārah* (lease) or stock trading).

Bay' al-'arbūn or *'arbūn* (a sale contract, in which a down payment is paid by the buyer) on the other hand, could be a very effective tool of risk management and an Islamic alternative to options. It should be noted that although the legality of *'arbūn* was disputed among the classical Muslim jurists, there is almost a consensus among contemporary scholars that it is a valid contract. On the other hand, asserting the legal status of *'arbūn* is of great importance in the use of *'arbūn* as an alternative to options. Therefore, the study will investigate whether *'arbūn* is a kind of liquidated damages or whether it is a kind of penalty or can be used as an exchange of the right to cancel the contract.

The present study will also investigate the sale of pure rights in the writing of classical scholars after expounding on the concept of right in Islamic law and how it could include pure rights, like that of options. It will also discuss the different cases involving the sale of pure rights accepted by Muslim jurists and draw an analogy between the sale of rights in these cases and the rights in conventional options. Finally, the study will address the relationship, if any, between options and gambling.

Objectives of the Research

The present study analyzes the pertinent issues on derivatives which have given rise to differences among Muslim scholars. Included among these derivative instruments are the forward, futures and options contracts. This study will critically address their compliance or lack thereof with Islamic principles. The study will also analyze the other Islamic alternatives available so that Islamic financial institutions do not find themselves in a disadvantageous position. To summarize the main points:

- The present study attempts to investigate the possibility of admitting the forward contract into Islamic law. This will include the forward

contract in commodities, the possibility of forward contract in gold trading and the forward contract in currencies. Thus, the study will analyze the legal grounds of these contracts and the different opinions advanced by modern scholars whether in favor of or against the acceptance of these contracts.

- The study will also investigate the permissibility of futures contracts by analyzing the different objections raised against the permissibility of other related contracts, such as the sale of debt for debt, the sale prior to taking possession, and speculation.
- An Islamic evaluation of the different functions performed by the clearinghouse, the futures brokers, and the regulation of the futures market is necessary for deciding the legality of the futures and options contracts in Islamic law. Reference will be made regarding these issues to the Malaysian Futures Industry Act and Securities Industry Act in order to see whether these modern forms of trading comply with Islamic principles or not.
- This study also elaborates on the permissibility of options contracts and the possible Islamic alternative based on *khiyār al-sharṭ* and *bayʿ al-ʿarbūn*. The sale of pure rights such as in the case of options is generally held not to be a valid subject matter of a contract in Islamic law. The study explores the issue based on the writing of classical Muslim scholars. It will also draw an analogy between the right of holding an option and other admitted rights in Islamic law as subject matter in order to identify any similarity or dissimilarity that may exist between them.
- Finally, the study will explore the relationship, if any, between options and gambling.

Research Methodology

The study is based on a selective study of Islamic law. It relies on the work of the major Sunni schools of Islamic Law, namely the Ḥanafī, Mālikī, Shafīe, Ḥanbalī, Zāhirī schools and the writing of modern scholars. Reference to the Imāmī School will only be made if it is derived from papers presented at the Islamic Fiqh Academy (Jeddah). The study does not support the opinion of a specific school of Islamic law and it is not under obligation to accept the opinion of the majority. But any opinion supported by evidence from the Qurʾān and Sunnah that could be the basis for solving certain problems related to futures trading may be used.

On the other hand, the study refers only to Malaysian Law in order to clarify or to compare the different aspects of futures trading discussed. In particular, references are made to the Malaysian Futures Industry Act and the Malaysian Securities Industry Act. However, this is by no means a comparative study; the Acts are used just for the sake of clarifying certain concepts or as a means of paving the way for certain analysis.

Organization of the Study

This study examines the concept of Derivatives trading in conventional sources on the different issues discussed, followed by the views of Muslim scholars, the sources of law they relied upon, and a critical analysis of these views.

Thus, throughout the study of the three different parts of derivatives instrument trading, namely, forward, futures, and option are examined from an Islamic point of view. The present research begins with the definition and concept of keys terms as they are elaborated in the conventional sources. Yet, as it is said in Islamic law, “a right judgment or ruling about anything is part of its accurate conceptualization” (*al-ḥukm ‘ala al-shai’far’ an taṣawwurihi*).

The conventional concept of derivatives trading, and in particular its contractual aspect, is followed by the opinion of Muslim scholars on the issue and the legal basis they advanced for its permissibility or not.

The study is nonempirical, and thus, it is based on library research. It is a critical analysis of the contemporary writings on forward, futures, and options trading from the Islamic point of view. It relies on the classical sources of Islamic law to approve or disapprove of the ideas discussed. This requires, first, an investigation into the different concepts raised in order to invalidate derivatives instrument trading, such as *bay’ al-kālī’ bi al-kālī’* or, more generally, the sale of debt where both countervalues are deferred to a future date after assessing the authenticity of the relevant “*ḥadīth*” (saying, deed and approval of the Prophet) and “*ijmā’*” (consensus of Muslim scholars on specific issue) about it.

Regarding the permissibility of trading gold on a forward basis, numerous arguments have been advanced on this issue. The present study will critically analyze the divergence of opinions and the evidence advanced on the issue, although a final decision would seem to require a collective *ijtihād* (the intellectual effort of Muslim jurists to

reach independent religio-legal decisions) due to the complexity and sensitivity of the question. The objective from addressing this specific issue is to state the fact that there is no economic or financial system unless there is a clear and unambiguous concept of money.

The study will also investigate the claim that the futures contract violate the principle of sale prior to taking possession, *bay' al-dayn bi al-dayn*, or it involves excessive speculation. This is because it is almost impossible to build a viable Islamic futures market without answering these problems. The main issues addressed in the present study with regard to options are how *khiyār al-sharṭ* and *bay' al-'arbūn* could be defined in order to be suitable Islamic alternatives to options. More important, the study will investigate the claim that the subject matter of contract in option is a pure right that could not be exchanged for a monetary value in Islamic law.

No English translation will be provided for Arabic terms which are commonly used in English works about Islam such as *Qur'ān*, *sunnah*, *sharī'ah*, *ijmā'and ḥadīth* while new terms such as “collective *ijtihād*” (or legal ruling based on the opinion of a number of Muslim scholars after discussion and consultation), *ḥaq māli* (right related to property) *ḥadānah* (custody), *ḥuqūq al-irtifāq* (rights of easements), and *tahjīr* (barren land) will be followed as possible by a brief English translation to clarify their meaning. A detailed table on the meaning of Arabic is attached for better reference.

Scope and Limitations of the Study

“The derivatives market is a market where traders buy and sell futures and/or options contracts to receive or deliver a specified quantity and grade of a commodity at a specified future time. The contracts are offered by authorized Boards of Trade commonly known as commodity exchanges.” Therefore, the scope of the present research is limited to the forward, futures, and options contracts in commodity markets, although at times references to shares market will also be made. Thus the forward, futures, and options contracts on currencies, bonds, and interest rates are not covered by this research due to their clear prohibition. Commodity in the present study means physical or tangible commodities, usufruct and right and not the general concept of commodity, which includes currencies, bonds, etc.

Meanwhile, although literally “right” is not a commodity, it is generally accepted in Islamic law that a right could be a subject matter of contract and could be bought and sold as any commodity. Because of this fact, the study of options which involve right trading is considered as part of derivatives trading contracts in the commodity market from an Islamic perspective. Moreover, the underlying asset in option trading could be a commodity and, therefore, there is a genuine need to study its legality from an Islamic point of view.

However, due to the importance of the forward currencies market in modern finance and its clear prohibition in Islamic law due to the involvement of *ribā*, several proposals on how to manage risk associated with currency fluctuation are discussed. There are many types of options, such as exotic options, compound options, options on options, lookback options, and others. However, the present study is only concerned with the basic types of options, namely, call and put options, which constitute the fundamental and most widely used kinds of options. Thus, the legality and benefit of other kinds of options depend on them. A call option gives the holder the right to buy an asset by a certain date for a certain price. A put option, on the other hand, gives the holder the right to sell an asset by a certain date for a certain price.

Outline of Chapters

The present analysis begins, in the first chapter, with a critical review of the major studies which have addressed the issue so far. The bulk of the study is then divided into three major parts: the forward market, the futures market, and the options market, in addition to the introduction and the conclusion.

The first part, subdivided into three chapters, addresses the forward market in commodities, the permissibility or otherwise of trading gold on a forward basis, and the forward market in currencies. Considering the fact that a forward contract, as it is applied in the conventional system, is a contract where both countervalues are deferred to a future date, the second chapter draws an analogy between this contract and the contracts of *salam* (A sale contract where two parties agree to carry out a sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid on spot, *istiṣnāʿ* (A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good at a given price on a given date in

the future and *bay' al-ṣifah* (Sale based on detailed description of the object of sale) in Islamic law. The second chapter also investigates the concept of *bay'al-kālī' bi al-kālī'*, that, of sale of the nonexistent and their relation with the forward contract.

Chapter 3 addresses the possibility of trading gold on a forward basis, and starts with a brief history of the world monetary system. That discussion is followed by a critical analysis of several *fatwās* on the issue of gold trading, and then expounds on the 'illah behind the prohibition of selling gold on a deferred basis and its implications on trading gold on forward basis.

The fourth chapter discusses the general rules regarding paper money and how a forward currency exchange will involve *ribā*. The chapter then proceeds to discuss the different possible alternatives to the forward sale in currency in order to ascertain their *sharī'ah* basis.

The second part of this study addresses the permissibility of the futures contract in Islamic law. Chapter 5 expounds on the different characteristics of a futures contract as distinct from the forward contract. This is followed by a brief history of the commodity market in general and the Malaysian commodity futures market in particular. The chapter touches also on the economic benefits of the futures market and some of the major objections raised to the futures contract such as speculation and financial crisis.

Chapter 6 elaborates on the assumption that a futures contract involves sale prior to taking possession or the sale of debt for debt. The opinion of Muslim scholars in this regard will be analyzed in order to ascertain their relevance to futures trading.

One of the important organizational features of futures exchange is the clearinghouse. It provides several crucial functions, such as the registration of contracts, the substitution of counterparties, the management of physical delivery, the settlement of contracts, and the monitoring of members' positions. This will be the focus of chapter 7. The chapter will also touch on the role of brokers, fidelity funds, and the trading offences in the futures market as it is stipulated in the Malaysian Futures Industry Act and it will assess their compliance with Islamic law.

The third part of this study comprises four chapters, all of which address the legality of options as a tool of risk management. Chapter 8 of the study will address the concept of options, their economic benefits, the difference between American and European options, major types of options: namely, call and put options, the exchange traded, and the over-the-counter options. It also touches briefly on the history of

options trading and the scope of options from an Islamic perspective. Moreover, the chapter discusses the claim asserting that options are a kind of gambling and provides a suitable response.

Chapter 9 focuses on *khiyār al-sharṭ* as a tool of risk management and as an alternative to options. The chapter also addresses the legal basis of this contract, the terms of the *khiyār*, the ownership of the commodity during the period of *khiyār*, liability for damage and loss during this period, and how *khiyār al-sharṭ* can be devised as tools to manage risk in *murābaḥah*, *ijārah* or stock trading.

‘*Arbūn* can be a useful tool of risk management. Chapter 10 of the present study investigates whether ‘*arbūn* is a kind of liquidated damages or whether it is a kind of penalty or an exchange of the right to cancel the contract for monetary value. The chapter will also address the use of ‘*arbūn* in currency exchange or *ṣarf*; ‘*arbūn* in commodities and services; ‘*arbūn* in shares trading; ‘*arbūn* in *murābaḥah* (a sale at a cost plus or with a specified profit margin) ‘*arbūn* in *salam* and ‘*arbūn* in *istiṣnāʾ*. Moreover, it will elaborate on the possibility of using ‘*arbūn* as an alternative to call and put options.

However, a successful Islamic options market would not be possible unless the legality of selling “pure rights” in Islamic law is addressed. This will be elaborated on in chapter 11. The chapter will analyze the concept of the sale of pure rights in the writing of classical scholars, after expounding the concept of rights in Islamic law and how it could include pure rights, like that of options. The chapter will also discuss the different cases involving the sale of pure rights that are acceptable to Muslim jurists and draws an analogy between the sale of rights in these cases and the right in conventional options.

Distinctive Features of the Research

One of the distinctive features of the present research is that it is selective research whereby the study is limited to the Sunni schools of Islamic Law. Moreover, with regard to modern legislation, reference is limited to the Malaysian law.

The present study is a multidisciplinary study in the sense that although it is initially a study in *fiqh* (Islamic law), it also includes discussions of *uṣūl al-fiqh* (Islamic Jurisprudence) ‘*ulūm al-ḥadīth* (science of the ḥadīth), conventional law, as well as some economic concepts.

LITERATURE REVIEW

Several institutional studies and a number of individual works have addressed the issue of derivatives and futures trading. The present study will divide its review of the previous studies into two sections, whereby opinions on the forward and futures contracts will be dealt with in the first section, while the second section will focus on options contracts.

*Forward and Futures Contracts**Institutional Studies*

The first institutional discussion about the legality of forward and futures contracts was undertaken by the Makkah-based *Fiqh* Academy.⁴ This present study will summarize the main points of the Academy's resolution and point out its shortcomings. The Academy acknowledges the benefits of forward and futures trading as follow:

- Forward and futures contracts provide opportunity for industrial and commercial institutions to finance their projects through the issuance and sale of stocks and financial instruments.
- They also provide a permanent venue for traders in commercial instruments and commodities.

However, this clear *maṣlahah* (Public interest as determined in the light of the rules of Shariah) according to the Academy's resolution is accompanied by transactions which are forbidden in the *sharī'ah*, such as gambling, exploitation, and the unlawful devouring of the property of others. The major objections to forward and futures contracts could be summarized as follow:

- Forward and futures contracts are by and large paper transactions and not genuine purchases and sales as they do not involve the delivery or taking of possession of their underlying commodities.⁵

⁴ For the complete text of the resolution, see Al-Majmā' al-Fiqhī al-Islāmī li-Rābiṭat al-Ālam al-Islāmī, *Qarārāt Majlis al-Majmā' al-Fiqhī al-Islāmī*, seventh session, from 11–16 Rabi' al-'Ākhīr, 1404, "Sūq al-'Awrāq al-Māliyyah wa al-Badā'i' (al-Būrṣah)," pp. 120–124.

⁵ Ibid.

- They entail oppressive practices on the part of those who engage in them through a kind of monopoly by making large sales and purchases of contracts in commodities, only to force smaller traders to take a loss and suffer hardship as a result.
- Forward and futures trading tends to bring about price distortion. Price is not entirely the function of market forces of supply and demand or genuine purchases and sales by parties who need to conclude a certain transaction. A variety of other factors are known to cause unnatural price fluctuation. These include not only cornering and profiteering by the market participants, but also false rumors and the like, which are detrimental to economic life and unacceptable from the viewpoint of the *sharī'ah*.
- Some economists have even called for the abolition of forward and futures contracts due to a number of historical events and crises that played havoc in the world economy and inflicted devastating losses on market participants at short notice due to the practice of these instruments.

Having highlighted the advantages and disadvantages of futures contracts, the Academy added that in view of these considerations and in the light of the relevant information on the nature of futures market transactions in financial instruments and commodities from the Islamic perspective, we observe that the benefits of futures markets are mixed with disadvantages which contravene the principles of the *sharī'ah*.

The Academy maintains that spot transactions, in which delivery takes place and the seller sells a commodity that he owns and which exists at the time of contract, are clearly valid from the *sharī'ah* point of view, provided that the transaction does not involve transactions or trading in unlawful substances such as alcohol.⁶

The Academy continues its argument that deferred contracts, which are concluded on the basis of a description of the asset and commodity which the seller does not own, are unlawful. This is because a person sells what he does not own but concludes the sale in the hope of subsequently purchasing the subject matter of the contract in order to make delivery later. This is forbidden in *sharī'ah* on the authority of the *ḥadīth* in which the prophet PBUH said, "Sell not what is not with you."⁷ Also, it is reported on the authority of Zayd Ibn Thābit that the prophet

⁶ Ibid.

⁷ Abū Dā'ūd, *Sunan*, vol. 3, p. *ḥadīth* no. 2187.

PBUH prohibited the sale of a commodity which is bought unless the traders take it into their possession and carry it.”⁸ Thus, according to the Academy the forward and futures contracts that are concluded in the commodities market do not qualify as *salam* sales, which the *sharī'ah* has validated. There are two reasons to support this:

- Forward and futures do not involve the payment of the price by the buyer at the time of the contract, which is a requirement in *salam*.
- Futures involve the sales of assets that have become personal obligations on the part of the parties involved. The first buyer in the chain does not receive the underlying commodity and such is the case with every other sale that follows suit. They all tend to be involved in giving or taking price differentials, like gamblers who undertake risks in a zero sum game in order to procure profit. In *salam*, on the other hand, the buyer is not permitted to sell prior to taking possession of the underlying commodity.⁹

It should be noted that despite the fact that the Academy acknowledges that futures trading involves different kinds of contracts, which need to be addressed separately, this is not reflected in its resolution. It is nevertheless clear that the contracts in stock indices are different from those in currencies or bonds and all these are quite different from those in commodities and shares. Moreover, the possibility of selling a purchased item before taking possession, or the sale of the *salam* before taking delivery are not explored despite the fact that many Muslim jurists have opted for their legality. Furthermore, the reason behind the possibility of deferring the price of *salam* in the Mālikī school has not been taken into consideration. Thus, the Academy resolution did not examine the different views that are available in the classical *fiqh* and has not attempted to come up with new alternatives that will guarantee the benefits it has recognized. However, it should be noted that our criticisms are based only on the resolution of the Academy. Unfortunately, we did not examine the different papers delivered in this session so as to obtain an accurate and precise evaluation.

⁸ Al-Ḥākīm, *al-Mustadrak*, Dār al-Ma'rifah, Beirut, vol. 3, pp. 39–40; Abū Dā'ūd, *Sunan*, Dār Iḥyā' al-Sunnah, Cairo, vol. 3, p. 283.

⁹ See Al-Majmā' al-Fiqhī al-Islāmī li-Rābiṭat al-'Ālam al-Islāmī, *Qarārāt Majlis al-Majma' al-Fiqhī al-Islāmī*, “Sūq al-'Awr āq al-Māliyyah wa al-Badā'i (al-Būrṣah),” pp. 120–124.

The position of the Islamic *Fiqh* Academy based in Jeddah regarding the stock market practices in general and derivative instruments trading in particular had evolved through different seminars and workshops where several papers were presented. However, in the seventh meeting of the Academy in Jeddah, a special session was devoted to the issue of derivative instruments trading. This session presented the main position of the Academy regarding futures trading, since the final resolution was issued thereafter. However, even the previous meetings had some merit in our evaluation of the Academy's stand. One may discover some personal views of the participants in these different meetings.

The first time the issue of futures trading was raised was in the sixth session in Rabat, Morocco, in 1989. However, no final resolution was reached although the general benefit of such a trade was recognized in the final communiqué and a call for further research on the issue was made. However, the single paper which discussed certain issues concerning options and futures was Mohamed Ali Elgārī's paper.

Concerning commodity forward and futures contracts, El-Gārī maintained that:

- Although there are some similarities between the forward and futures contracts on one hand and *bay' al-salam* on the other, in *salam* the price must be paid at the time of the conclusion of the contract, which is not the case in forward or futures contracts.
- The transaction, he added, will be a kind of *bay' al-kālī' bi al-kālī'*, which is prohibited.
- El-Gārī pointed out that if we consider *salam* as a contract in accordance with *qiyās* (analogy), then there is room for the admissibility of these contracts. Unfortunately, he did not elaborate on this possibility.
- He also argued that in futures contracts, the commodity in the first contract could be sold prior to taking possession, which is not the case in *salam*. However, he added that there is room for approving such transaction since some scholars did not see any legal problem in selling the *salam* prior to taking possession. El-Gārī once again did not expound this possibility. He raised the point that the '*illah*' or cause of prohibition of many contracts here is risk-taking or *gharar*. It is a complex issue, he added, which needs a careful investigation in relation to the modern types of contracts. Unfortunately, he did not proceed further, although many of the objections he raised pertaining to *gharar* may not necessarily exist in the modern types of futures contracts.

- El-Gārī also compared futures contracts with *istiṣnāʿ* and concluded that both types of contracts involve *bayʿ al-kālī bi al-kālī*.¹⁰ But he considered the view that a *istiṣnāʿ* or *muqāwalah* contract should be approved by Islamic law on the basis of necessity or *ḍarūrah* (necessity). However, one may ask if *istiṣnāʿ* is admitted on the basis of *ḍarūrah*, why not admit futures and forward contracts on the same ground?

It is worth noting that El-Gārī's position on this issue has not changed much in the nine years since this session was held. Thus, in a seminar entitled *Islamic Financial Services and Products* held at the Institute of Islamic Understanding, Malaysia, August 1998, he reiterated almost the same thing about futures in his paper entitled "Futures Trading—Islamic Perspective." However, he concluded: "Building a model of futures trading on the basis of a *salam* contract should not be excluded altogether." Unfortunately, he did not go beyond that to explore this possibility.

Returning to our discussion of the Academy position, it should be noted that El-Gārī's paper was followed by a discussion session, which deliberated primarily on the essence of these new types of contracts. The session ended without resolution regarding futures or options.

The sixth session of the Islamic Fiqh Academy which discussed futures trading was followed by another session in Bahrain in 1991, jointly organized by the *Fiqh* Academy and the Islamic Research and Training Institute (IRTI) affiliated with the Islamic Development Bank.¹¹ However, the session in its final communiqué endorsed the resolution issued by the *Fiqh* Academy based in Makkah and reproduced its resolution word for word with regard to forward and futures commodity contracts and called for further research on the issue of options. Unfortunately, we have not been able to go through the different papers presented so as to give an accurate evaluation of the session or perhaps to come across some personal views. However, from the resolution it is clear that the participants have reiterated the same arguments and analysis

¹⁰ It seems the author based his argument on the majority's view that *istiṣnāʿ* should fulfill the conditions of *salam* including the payment of the price at the time of the contract. However this view has been overruled even by the Islamic *Fiqh* Academy in its resolution no. 66/3/67, one year after he presented his paper.

¹¹ The session was held under the auspices of the Islamic bank of Bahrain from 25–27 November 1991.

presented in the Makkah-based Academy, and eventually came to the same conclusion.

Thus, it could be said that the Jeddah session in 1992 represents the real position of the Academy regarding derivative instruments. Different rulings related to stock market trading in general and derivative instruments trading in particular have been passed in resolution no. 64/1/7.

Regarding the forward contract in commodities markets in particular, the ruling was that it is an illegal type of contract since both counter-values are deferred. Nevertheless, it could be modified so as to fulfill the established conditions of *salam*. Moreover, it is not permissible to sell the commodity in the first *salam* before taking delivery.

As for commodity futures, where the contracting parties could offset their position through a similar contract, the resolution considers it an illegal contract as a matter of principle.

Concerning the foreign currency exchange, similar rulings have been issued. Namely, spot foreign exchange is permissible if it fulfills the conditions of the classical *ṣarf* contract, while the forward and futures foreign exchange are declared to be illegal. Concerning the trade on stock indices, the resolution described it as pure gambling.

On the other hand, the Academy recognized the role of brokers (*samāsirah*) in the stock market and considered the role as part of a lawful public interest. However, it passed a negative judgment on the issue of the selling of interest-based loans from the brokers and the selling of shares not yet possessed by the seller.

In its recommendations the Academy called for the establishment of an Islamic stock market based on *salam*, *bay' al-ṣarf*, the promise to sell in the future, *istiṣnā'* and other types of Islamic alternatives. Last, the Academy called for detailed studies on the different Islamic alternatives and their modes of implementation. Perhaps because of this requirement, the issue was raised once again in 1993. However, the resolution passed therein confirmed what had been decided in the previous resolution regarding the issue of futures trading.

Given the fact that resolution no. 64/1/7 is the resolution which concerns us most in our study of futures trading, it is necessary to give a brief review of the different papers presented and the follow-up discussions to understand the rationale behind the Academy's resolution.

Six papers were presented on derivatives trading. Five of them were on options (*ikhtiyārāt*) and were presented by Mohammad Mukhtār al-Salāmī, Wahbah al-Zuhailī, Ṣiddīq al-Ḍarīr, 'Abd al-Wahhāb abū

Sulaimān, and ‘Abd al-Satattār abū Ghuddah. The last paper was on commodity futures, and it was presented by Muhammad Taqī al-Usmānī, That paper will be reviewed in this section while the papers on options will be studied in the following section.

In his single paper about commodity futures, Taqī al-Usmānī concluded that the futures contract is a *ḥarām* (not permissible) transaction for the following reasons:

- It does not fulfill the conditions of *salam*, which requires payment of the price at the time of the contract.
- Futures contracts are a kind of *bay‘ al-kālī’ bi al-kālī’* and, therefore, they are not permissible in Islamic law. However, Sheikh Taqī did not discuss the weakness of the hadith.
- Generally, no delivery is possible in these contracts and the commodity is sold again and again prior to taking possession, which is not permitted in *salam*¹² despite the difference of opinion on the issue.

The discussions of commodity futures fared somewhat better in elucidating the different issues related to commodity futures and opposing and clarifying some of Sheikh Taqī al-Usmānī’s generalizations. Nevertheless, to allocate just one brief paper to such an important issue, which has a major effect on the Muslim economy, falls short of expectations, especially from a highly respected institution. Furthermore, despite the fact that some of the participants defended the public interest or *maṣlahah* behind commodity futures, this stand was not reflected in the Academy’s resolution. I do not propose to discuss everything in this review, but just show how the Academy’s resolution had been made on very simplistic grounds. Many issues, which were to be discussed, were left out. Moreover, if all necessary conditions were taken into account, and another session were held on this subject, before reaching any resolution (as one of the participants—‘Abd al-Salām al-‘Abādī—suggested during the discussion on options), one could have expected some different resolutions.

What is needed from the Academy, as a respected academic forum, is to address the controversial issues on the subject. For instance, they need to examine the authenticity of the different rulings formulated by

¹² Taqī al-Usmānī, “Uqūd al-Mustaqbaliyyāt fi al-Silaa’,” *Majallat Majma’ al-Fiqh al-Isālmī*, 1992, no. 7, vol. 7, p. 275.

some classical scholars based on the weak *ḥadīth* about *bay' al-kālī bi al-kālī* and the alleged *ijmā'* (consensus¹³ on the subject, although some scholars have already disputed its authenticity. The Academy would have done a great service if it had ascertained the *'illah* (effective cause, *ratio legis*) behind the prohibition of sale prior to taking of possession; the *'illah* (effective cause, *ratio legis*) behind the *ḥadīth* “do not sell what is not with you” whether the application of these principles would differ in an organized market like that of futures and compared to ordinary market; the sale of “right” and the reasons why some schools allowed it while others prohibited it? And why did the latter-days Ḥanafī scholars change the *fatwā* of the *madhhab* about the sale of “right” when they were confronted by the change of custom? If these issues and other important subjects related to the legality of futures and options had been systematically discussed, one might have expected a different resolution from the Academy. Unfortunately, nothing of that nature actually happened.

Another institution which addressed the issue of futures trading is the Permanent Research Committee of the Board of Great Scholars in Saudi Arabia in its study entitled “Min Ṣouwar al-Burṣah” (*Forms of Stock Markets*), divided into three lengthy articles in *Majallat al-Buḥūth al-Islāmiyyah*.¹⁴ The study quoted many verses and *aḥādīth* (saying of the Prophet) related to *ribā* with their commentary from the traditional works, including *Tafsīr al-Qur'ān al-'Azīm* of Ibn Kathīr; *Aḥkām al-Qur'ān* of Ibn al-'Arabī; *Fath al-Bārī* of Ibn Ḥajar; and *Nayl al-Awtār* of al-Shawkānī. In addition, parts of some familiar *fiqhī* books, such as *Bidāyat al-Mujtahid* of Ibn Rusḥd and *al-Mughnī* of Ibn Qudāmāh, were reproduced. The committee also reproduced the descriptive research on futures trading submitted by the director of the Saudi Monetary Agency with brief commentaries in the footnotes. In the last part of the study, the committee reproduced the works of some contemporary Muslim jurists, which seem to legalize parts of the transactions in futures contracts. Thus, they quoted a *fatwā* from Rashīd Ridā in his reply to some traders in the futures cotton market, and part of Moḥammad Yūsuf Muṣā's book *Fiqh al-Kitāb wa al-Sunnah fī al-Mu'āmalāt*

¹³ Regarding the weakness of the *ḥadīth* and the debate on the *ijmā'*, see chapter 6 of the present study on the sale prior to taking possession and the sale of debt for debt.

¹⁴ General Secretariat of the Great 'Ulamā's Board, *Majallat al-Buḥūth al-Islāmiyyah*, Riyadh, Saudi Arabia, 1996, no. 46, pp. 26–140; no. 47, pp. 23–120; no. 48, pp. 27–90.

al-Maṣrifīyyah, followed by some commentaries in the footnotes to refute their argument.

What we want to stress here is that despite its respectable standing as an influential institution, the Board's study lacks reasonable analysis. It has tried to apply just the interpretations of Muslim jurists in the past centuries to contemporary problems. Yet, while the *sharī'ah* is sacred and unchangeable, the *fiqhī* interpretations can change according to time and place and according to *maṣlahah*. Moreover, passing a prohibitive judgment is in no way going to solve the problem. In contrast, it may raise doubts among some people about the ability of *sharī'ah* to respond to contemporary problems. Yet, such a prohibitive judgment without proposing a viable alternative did not and will not change anything in business practice; the oil and other basic commodities from the Muslim countries will continue to be traded according to supposedly forbidden contracts without any Islamic input. Finally, if such simplistic attitudes on the part of those who are learned people in Islamic law have not changed, the possibility of freeing Muslims from *ḥarām* transactions looks very remote. Yet, the existence of some Islamic financial institutions here and there with deposits estimated at less than 5 percent¹⁵ of the market share of the Muslim economies is not a real solution.

Individual Studies

As we have mentioned before, besides the institutional discussions, several individual works also addressed the issue of futures trading and derivatives. However, two different approaches characterized these studies. The first approach lays emphasis on the need to purify the conventional types of futures trading contract in order to bring it in line with Islamic principles. At the same time, it aims at rebutting some of the criticisms raised by certain Muslim scholars against futures contracts. The second approach, on the other hand, rejects the western types of

¹⁵ The Central Bank of Malaysia in its Annual Report (2000) stated that for the year 2000 the Islamic Banking sector registered a strong performance in tandem with the continued improvement of the Malaysian economy. The market share of the Islamic banking system increased to 6.9 percent during the year from 5.5 percent in 1999. (See Nik Norzrul Thani, *Legal Aspects of the Malaysian Financial System*, Sweet & Maxwell Asia, 2001, p. 165.). In the Gulf Cooperation Countries the market share is 5–10 percent (see, Hossein Askari & Zamir Iqbal, "Opportunities in Emerging Islamic Financial Market," *BNL Quarterly Review*, 1995, p. 260.)

derivative contracts and tries to formulate a purely Islamic alternative based on the existing types of Islamic contracts.

The first study which addressed the issue of derivatives contracts from an Islamic point of view was Muhammad Akram Khān's study entitled "Commodity Exchange and Stock Exchange in Islamic Economy," published in 1988 in the *American Journal of Islamic Social Sciences*.¹⁶ The author discussed first the general principles of the market's functioning in Islam before addressing the validity of the forward contract. He maintained that Islamic law provided for situations involving forward transactions, different contracts such as *bay' al-salam bay' al-istiṣnā*, *al-bay' al-mu'ajjal* (deferred sale) and *bay' al-istijrār* [A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment] and concluded that "There is hardly anything objectionable in the basic operation of the forward market." However, he admitted that "Individual transactions may have certain elements which need to be modified in the light of Islamic law." Unfortunately, he did not specify these elements or how the modification would be implemented.

Addressing the legality of futures contracts, Muhammad Akam Khān maintained that:

- A futures contract involves the sale of a nonexistent commodity and does not involve physical delivery; therefore, it is unlawful.
- Moreover, according to Akram Khān, speculators are the winners, small investors hardly ever win, brokers carry out dual trading by conducting business to their account first, which regulation fails to eradicate, and manipulation persists despite all the safeguards undertaken so far.

However, Sayyid Abdul Jabbār Shahhabudīn, the chief executive of the Kuala Lumpur Commodity Exchange, dismissed these shortcomings, contending that there are adequate safeguards to protect users of the market, such as the time-stamping of orders, the prohibitions of trading ahead or against clients' orders, the segregation of clients' accounts,

¹⁶ Muhammad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," *American Journal of Islamic Social Sciences*, vol. 5, Issue no. 1, 1988, pp. 92–114.

reportable position and position limit, etc. Moreover, there is a free flow of information into and out of the market on a real time basis around the world.¹⁷

Addressing the issue of currency exchange, Akram Khān concluded that the conventional spot currency exchange, which allows a two-day lag, cannot be accepted in an Islamic framework and the alternative could be that the exchange is effected simultaneously by involving correspondent banks or agents at the same time. Regarding the forward currency exchange, he concluded that it is illegal in Islam. Moreover, he added that “At best the two banks ‘agree’ or ‘promise’ to transact an exchange business at a future date. Such an agreement is only morally enforceable and no court in an Islamic state would enforce it.”

However, the categorical rejection of the possibility of enforcing such a promise¹⁸ may not be justified. This is true because of the decision of the Islamic Fiqh Academy endorsing such an “agreement” as enforceable in the sale of *murābaḥah*, and the extension of this rule by some scholars to currency exchange. Moreover, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in its standard on currency has clearly endorsed the permissibility of such transaction.

The author ruled out any possibility of swap and futures currency exchange in the Islamic economy while admitting that the need for Islamic financial institutions to deal in forward and futures transactions arises, partly, from the desire to invest their surplus funds over short periods of time. Regarding options trading, he compared it with *bayʿ al-salam* and *bayʿ al-khiyār* (sale with option) and concluded that it did not fulfill the conditions of either of the two contracts and, therefore, options trading is unlawful.

The most extensive and in-depth analysis of futures trading so far is Mohammad Hāshim Kamālī’s work entitled *Islamic Commercial Law: An Analysis of Futures and Options*. The study addressed the major points on futures and options from the Islamic point of view. It also represents the

¹⁷ Sayyid Abdul Jabbar Shāhābudin, “Comments on Muhammad Akram Khān’s Commodity Exchange and Stock Exchange in an Islamic Economy,” *Journal of Islamic Economics*, International Islamic University Malaysia, vol. 1, issue 2, July 1988, pp. 71–76.

¹⁸ For a detailed discussion regarding the issue, see chapter 4 of the present study.

major work in the first approach to adopting futures contracts in Islamic law. This approach, as we have mentioned before, is mainly concerned with the elimination of the un-Islamic elements in futures trading and with refuting some of the criticisms against futures trading.

The author reviewed the major literature available on the subject and the opinion of different scholars either in favor of or against futures and option trading. But the important study missing is that of the Jeddah-based Islamic *Fiqh* Academy. Thus, Kamālī rebutted for instance ‘Umar Charpa’s criticism of short selling; he rebutted Akram Khān’s interpretation of the *ḥadīth* injunction, “Sell not what is not with you;” and he rejected Aḥmad Yūsuf Sulaimān’s interpretation of some *fiqh* rulings, such as the sale of the nonexistent, and the resolution of the Islamic *fiqh* Academy based in Makkah. Then, he gave a brief history of futures trading.

It should be noted that despite the fact that the author traced back the origin of futures trading to the forward contract and touched upon the differences between the two types of contracts, he did not address separately the legality of the conventional forward contract from an Islamic perspective. Yet, it could be said that establishing the legality of futures contracts implies that the legality of forward contract is also established. However, it is likely that a separate discussion will have its own merit. Some Muslim investors may be convinced of the legality of the forward contract and remain reluctant about futures. This is partly due to the rejection of futures contracts by some influential Islamic institutions and, on the other hand, due to its recent introduction in the financial market.

Moreover, *salam* and *istiṣnā’* contracts, which have some similarities with the modern forward contract, also have some differences and, therefore, could not be considered as the absolute alternative to the conventional forward contract, although they fulfill some of its objectives. Furthermore, the majority of Muslim jurists are still reluctant to accept the modern forward contract and insist that it should fulfill the conditions of *salam*. In addition, if the futures market is still at its early stages in the Muslim world, it may take time to be widely implemented; the forward contract is already in use in every Muslim country despite the negative judgment about its validity given by the majority of contemporary Muslim jurists. Nevertheless, it is a necessary economic tool that would be applied regardless of the juristic position. Perhaps for this reason, some have even considered it as a pressing need (*mimmā*

ta'ummu bihī al-balwā or a general need).¹⁹ What we are trying to say is that a few pages about forward contracts would have added to the merit of Kamālī's study.

Kamālī then discussed the benefits of the futures contract and its validity on the basis of *maṣlahah* or public interest. Further, he outlined the differences between futures contracts and the classical types of contracts. He described in detail the market procedures and technicalities of trading in futures and options and the main players, such as the clearinghouse, the hedgers, and speculators. However, considering the magnitude of the study, the Islamic analysis of the issue of speculation and hedging in particular is insufficient to address all relevant issues. What concerns us more here is the *fiqhī* discourse on futures trading.

Kamālī then proceeded to discuss some of the immediate issues about futures trading, such as uncertainty and risk (*gharar*); he examined the jurists' analysis about the existence of the subject matter in a sale contract; he further mentioned the sale of unseen (*bay' al-ghā'ib*) commodities and the different interpretations of the *ḥadīth*, "Sell not what is not with you." The analysis of these issues has been thoroughly dealt with, and the present study will only add more evidence from the classical sources of Islamic law to strengthen the argument already advanced. However, other issues discussed by Kamālī in this connection, which seem to be in need of elaboration, are the issues of sale prior to taking possession, debt trading, or *bay' al-dāyn bi al-dāyn*, and speculation.

Having analyzed the different principles related to futures contracts and having refuted some contending opinions, especially those of Yusuf Sulaimān,²⁰ and the resolution of the Makkah-based *Fiqh* Academy and 'Abd al-Bāsīt Mutwalī's fatwā,²¹ Kamālī gave his approval to the main legal features of futures contracts. His discussion of the *ḥadīth*, "Do not sell what is not with you," led to the conclusion that it applies only to sales involving specific objects and not to fungible goods. Moreover,

¹⁹ See the Islamic *Fiqh* Academy guideline for research papers to be submitted as part of the forthcoming Encyclopedia of *fiqh* related to economic issues *Majallat Majma' al-Fiqh al-Islāmī*, no. 9, vol. 4, p. 766.

²⁰ Yusouf Sulaimān, "Rai' al-Tashrī' al-Islāmī fi Masā'il Burṣah", *al-Mawsū'a'h al-'Ilmiyyah wa al-'Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Bank, vol. 5, pp. 428–443.

²¹ Bayt al-Tamwīl al-Kuwaiti, *Al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtisādiyyah*, Kuwait, 1988, p. 528.

the *ḥadīth* is mainly concerned with the prevention of *gharar* and “since delivery is always guaranteed by the clearinghouse procedures, the seller’s ability to deliver is not a matter of concern in futures trading.” Regarding *bay‘ al-kāli‘ bi al-kāli‘*, he concluded that there is no definitive statement in the sunnah of its prohibition, the Qur’ān’s *‘āyat al-Mudāyanah* validated deferred sales, and the manifest texts seem to accommodate an affirmative ruling on futures trading.

He sustained his conclusion by discussing the opinion of some contemporary Muslim jurists, who expressed a positive judgment on some aspects of futures trading, such as Ali ‘Abd al-Qādir²² in his comment on Sulaymān’s article; ‘Abd al-Karīm al-Khatīb in his book *al-Siyāsah al-Māliyyah*;²³ al-Jundī in his book, *Mu‘āmalāt al-Burṣah*,²⁴ Aḥmad Muḥyi al-Dīn who defended vigorously the forward contract in one of his books but raised some reservations about it in his later book,²⁵ and Majd al-Dīn ‘Azzām in his reply to ‘Abd al-Bāsit’s fatwā.²⁶

We would like to make a brief comment here regarding Majd al-Dīn ‘Azzām’s methodology that is not addressed by Kamālī’s work. Although Majd al-Dīn’s conclusion is correct, part of his methodology might not be acceptable. He maintained that the norm concerning *mu‘āmalāt* or Islamic commercial transactions is permissibility, which means that contracts are generally permissible unless they are clearly prohibited by the texts (*nuṣūṣ*). This prohibition could be either definitive (*qaṭi‘*), which leaves no room for doubt, or speculative (*zannī*), such as the prohibition conveyed in a solitary *ḥadīth* (*ahād*). ‘Azzām added that we fully accept and rely on the first part of this principle, but concerning its second part, he asserted that the prohibitive evidence pertaining to civil and commercial transactions must not be anything less than decisive. This is because the fundamental permissibility of such transactions is based

²² *Al-Mawsū‘ah ‘al-‘Ilmiyyah wa al-‘Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Banks, vol. 5, pp. 444–451.

²³ ‘Abd al-Karīm al-Khatīb, *al-Siyāsah al-Māliyyah fi al-Islām wa Ṣilatuhā bi al-Mu‘āmalāt al-Mu‘āsirah*, Dār al-Fikr al-‘Arabī, Cairo, 1976.

²⁴ Al-Jundī, Mohammad Shahhāt, *Mu‘āmalāt al-Burṣah fi al-Sharī‘ah al-Islāmiyyah*, Dār al-Nahdah al-‘Arabiyyah, Cairo, 1988.

²⁵ Aḥmad Ḥassan Muḥyi al-Dīn, *‘Amal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-‘Ālamīyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ‘Athārūhā al-‘Inmā‘iyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

²⁶ Bayt al-Tamwil al-Kuwaitī, *Al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, p. 590.

on decisive evidence, that is, the principle of *ibāḥah*, and this should prevail unless there is decisive evidence to warrant the opposite.²⁷

It is worth noting, however, that rejecting any prohibition based on a solitary *ḥadīth* (*āḥād*) is a dangerous precedent which may lead to the rejection of the sunnah. Yet, there are some differences of opinion about the acceptance of a solitary *ḥadīth* in the area of *‘aqīdah* (belief and creed) but not in *mu‘āmalāt* (commercial transaction). Thus, it seems that by adopting such a methodology Majd al-Dīn undermined some of the credibility of his argument, although it is basically correct.

Another scholar who addressed the legality of futures trading in Islamic law is Fahīm Khān in his book *Islamic Futures and their Markets*.²⁸ However, unlike Kamālī, he limited himself just to futures contracts. The study represents another approach in tackling the issue of futures markets from an Islamic perspective. Departing from the previous approach adopted by some scholars, where the main focus was to identify the non-Islamic elements in the futures market for modern commodities, and to look for the Islamic alternative, Fahīm Khān preferred to choose *bay‘ al-salam* [a sale or purchase of a deferred commodity for the present price] as the basis for any Islamic futures market. Yet, he discussed briefly *istiṣnā‘* and *ju‘ālah* [(A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties.)] as possible classical contracts with features of futures trading as well. He stressed that “we are not looking forward to ‘Islamizing’ an intrinsically non-Islamic activity, but instead we are trying to revert to our own traditions to develop similar institutions that would not only bring the parallel economic benefits to the society that they are meant to provide but that will also be in line with Islamic legal framework.”²⁹

However, it seems that such a methodology has little merit by itself since “wisdom is the lost property of a Muslim who is its rightful owner wherever he gets it.” The author submitted to the fact that even in his approach to an Islamic futures market, the major structures of the conventional futures market were still needed. Thus, there is a need for establishing an exchange as a central place where buyers and sellers meet

²⁷ See Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, al-Kuwait, 1985, pp. 527–545.

²⁸ Fahīm Khān, *Islamic Futures and their Markets with Special Reference to Their Role in Rural Financial Market*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, 1995.

²⁹ *Ibid.*

to undertake transactions. There is also a need for a statutory agency to regulate and monitor the futures market and a clearinghouse in order to facilitate and regulate the enforcement and settlement of contracts or the principle of standardization of the futures market. Yet, Fahīm raised some points of difference between the conventional procedure of the clearinghouse and that of an Islamic one stressing that “the clearinghouse of an Islamic Futures exchange will not serve as another party in any futures contracts. It will serve only as a guarantor that all contracts are honored.” However, he acknowledged that there might be some problems in such a mechanism. He concluded, the “clearinghouse in this model will no more be involved in such silly and irrational activities as selling to or buying from itself.”

Nevertheless, there seems to be nothing in Islamic law which prohibits a person from being an agent for the buyer and the seller at the same time if he is acting in good faith. Moreover, the agent would be responsible for any liability if the contractual agreement stipulates so.

Addressing the scope of futures trading in an Islamic framework, Fahīm Khān concluded rightly, concerning stock indices, that it is nothing but pure gambling in word and spirit that is played in the market place. Concerning a foreign currency exchange, he acknowledged the need for an Islamic concept of foreign currency futures although he did not elaborate on the subject.

The author also addressed the problem of speculation. Although he was critical throughout his discussion, he rightly concluded that dealing in the market does require speculation on price. But we have to distinguish between two types of speculation, particularly regarding the futures market. One form of speculation is not related to any real activity and is meant to be merely a financial or monetary transaction or nonproductive exchange. This should be disallowed as it falls under the category of gambling. The other aspect of speculation is the one that is part of some real activity and helps in shifting risks from the vulnerable producers, who cannot afford bearing all the risk, to those who can afford to bear it. Such speculation is desirable and permissible. Similarly, activity that provides liquidity to farmers to improve production decisions, or enables them to increase the volume of their production, is also desirable and permissible, even if it involves speculation on futures prices.³⁰

³⁰ Ibid., p. 46.

Since the solution to the problem of liquidity is one of the major objectives of a futures market, Fahīm Khān tried to reconcile his suggested *salam*-based futures market and the problem of liquidity. He argued that such a market provides liquidity to the producers rather than to traders and curbs speculation. However, in a *salam*-based futures market, as suggested by Khān, advance payment is necessary and as a consequence even genuine traders may face liquidity problems which may be a serious hindrance for the development of such a market. Another problem which may arise as a result of advance payment is the problem of matching the sellers and buyers of futures contracts. Khān acknowledged this by saying “this too may not be very conducive in creating competitive conditions in the Islamic futures market.” To solve the problem, Khān suggested that these “shortcomings arising out of liquidity constraints upon traders can be overcome by the introduction of Islamic banks or of specialized Islamic financial institutions to finance the futures trading.” However, it seems that such a mechanism would not be without practical problems, especially when we know that earlier failures by Islamic banks to practice *salam* was mainly due to certain policies adopted by these banks.³¹

On the other hand, concerning the relation between the futures and cash market and the effect of hedging, Fahīm Khān argued that “since the futures market and cash market are independent, a farmer will hardly be a good player in the futures.” However, this argument seems to be fundamentally incorrect since it ignores arbitrageurs and arbitrage activity. Furthermore, any market or instrument that consistently exploits one party of the transaction will see its trading volume reduced and will die out naturally. This is because the constantly losing party would be naturally unwilling to continue using this instrument.

However, Fahīm Khān’s fiqh analysis throughout the discussion is shallow. For instance, he did not make any effort to ascertain the possibility of selling the *salam* countervalues before taking delivery. Although he raised the difference of opinion among the jurists, he did not proceed to analyze the different evidence advanced and the *ratio* behind the prohibition or legality of such a sale. Moreover, the effect of such analysis on the development of the futures market is totally absent,

³¹ See Samī Ḥammūd, “Ṣiyagh al-Tamwīl al-Islāmī Mazāyā wa ‘Aqabāt kulli Ṣīghah,” *Abḥāth Nadwat Ishām al-Fikr al-Islāmī fi al-Iqtisād al-Mu’āṣir*, held in Washington from 6–9 September 1988, International Institute of Islamic Thought, 1992, pp. 193–247.

despite the author's acknowledgement that a prohibitive judgment may be a hindrance for the development of a secondary market. The same problem of juristic analysis is obvious in Fahīm's disregarding of the Mālikī's opinion, which allows deferring the payment of *salam* for three days; or the opinion of some modern writers that it is necessary to install such payment in *salam* in order to solve the liquidity problem which may face even genuine traders.

Another commentator who addressed the issue of futures trading is Husein Salmon. His paper is entitled "Speculation in the Stock Market from the Islamic Perspective."³² It should be noted that many commentators have considered futures trading invalid because of the problem of speculation involved. Salmon acknowledged that some degree of speculation is essential in any financial activity. However, some issues he raised about speculation may not be easily accepted. He divided speculators into two types: first, there are careful investors who invest their capital after making a careful assessment. They analyze the strengths of the company based on reliable fundamental factors, including real assets and property as well as the performance of the company in the past. This is what he termed rational speculation.

The second kind of speculators are those who do not conduct any study or analysis. They study the trend of price movements and market sentiment, and sometimes they base their decisions to buy on whispered rumors in the market. The evaluation of the second group may not be totally accepted due to the fact that rumors and manipulation are unacceptable in principle in the Islamic stock market, and, therefore, to invalidate futures trading on this aspect is baseless. On the other hand, many other commentators, without any legal grounds, have also advanced the claim that any benefit from price movements or price fluctuations is not legitimate.³³ Salmon suggested that it is necessary that traders keep their shares for at least six months to one year before selling them to a third party.

³² Husein Salmon, "The Problem of Speculation in Stock Market from an Islamic Perspective: Investment as an Alternative," *The First International Conference on Islamic Management: Management of Economic Development in an Islamic Perspective*, Jointly Organized by the Islamic Development Management Project (IDMP), The School of Social Sciences, University Sains, Malaysia, and the Islamic Research and Training Institute affiliated to Islamic Development Bank (IDB), Jeddah, Saudi Arabia, from 8–10 December 1998, pp. 1–50.

³³ See chapter 5 of the present study for more elaboration on the issue of speculation.

It seems that there is nothing in Islamic law which prevents a person from buying and selling without having the intention to make use of the commodity or to keep it for a long time. The topic will be investigated later since many commentators rely on it as grounds to invalidate futures.

Salmon calls for a total exclusion of options contracts because they bring additional uncertainty and they are not comparable to *bay' al-salam*. He rejected the possibility of taking a fee for a premium or option without any discussion. However, it seems that there are no grounds for comparison between the two contracts. On the other hand, his criticisms of short-selling and margin sale deserve consideration.

Furthermore, Aḥmad El-Ashkar in his article, "Towards an Islamic Stock Exchange in a Transitional Stage," observed that speculation could hardly be viewed as a game of chance or be equated with gambling. He pointed out the difference between speculation and *najash* (to bid up the price of the item, not with the intention to purchase the item, but rather to raise the price for the customers intending to deceive the buyers) to refute the allegations of some scholars. He concluded that "the Islamic securities Market should not be envisaged as a speculation-free market. A reasonable degree of speculation would be required, and indeed needed, if the market is to be active and operative."³⁴

Frank E. Vogel and Samuel L. Hayes III in their study *Islamic Law and Finance, Religion, Risk, and Return* also dealt with the issue of derivatives and futures trading. Concerning the sale of debt, especially that of *bay' al-kālī' bi al-kālī'*, they acknowledged that the profound implication of the prevailing restrictions in this area may be an obstacle for the development of a futures market. Thus, they maintained that

On such matters Islamic law has many complex rules, all designed to avoid *ribā* and *gharar*. The restrictions these rules impose were less important in the past, when most contracts were promptly executed on at least one side. However, in today's world, futures financial obligations are among the most important forms of property; indeed, such obligations are the core of many forms of investment traded in huge volumes in financial markets. Accordingly, Islamic law restrictions in this general area are very significant in the development of new instruments, particularly if these are to be traded on secondary markets.³⁵

³⁴ Aḥmad El-Ashkar, "Towards an Islamic Stock Exchange in a Transitional Stage," *Islamic Economic Studies*, Islamic Development Bank, Jeddah, Saudi Arabia, vol. 3, no. 1, December 1995, pp. 79–112.

³⁵ Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, Kluwer Law International, The Hague, 1998, p. 114.

However, their discussion regarding the issue is very shallow and almost followed the conservative approach. We may be able to understand the reason behind this conservative approach if we examine their methodology in this area. For instance, they maintained that

Of course the most direct way to achieve the goal of risk management would be a bold redirection in *fiqh* thinking (*ijtihād*) drawing on new interpretations of the revealed sources and of basic principles. This *ijtihād* will declare what about risk management is legitimate in Islamic law, and what is illegitimate. But... it is ordinarily the most conservative, literal and legalistic approach that are followed in Islamic finance and accordingly, ..., we will follow only such an approach. While doing so, however, we should try not to lose sight of the larger issue just sounded the proper scope, if any, for risk management in Islamic law.³⁶

At the end of their discussion on the sale of debt for debt, they concluded that the general agreement among the scholars including Ibn Taymiyyah is against the bilateral executory contract; the force of the debt for debt maxim in this matter is unlikely to dissipate soon. They went on to argue that recently two authors have argued for its reversal. One did it on the ultimate ground of necessity,³⁷ while another offered more nuanced and challenging arguments. He argued that delayed payment should be permitted in supply contracts until the goods are delivered even for fungible goods or goods by description. Pointing to the more liberal rules that apply to delay in contract with an *ʿayn* (tangible property) on the one side, he argued that, first, the central distinction between *ʿayn* and *dayn* (debt) should not rest on whether the goods are unique, but on whether they already exist. Second, where goods under a supply contract are continuously available in the market, the contract should tolerate postponement of paying until the goods are received, just as they would if the goods were *ayn*. The Maliki position requiring payment delay in sales of absent *ʿayn* should apply to such modern contracts.³⁸

However, the point which we would like to make here is that to claim that just two authors have argued for the reversal of the prohibition to postponing both countervalues is out of touch with reality. Many Muslim scholars have argued against this maxim, sometimes even before Nazīh

³⁶ Ibid., pp. 154–155.

³⁷ Nazīh Ḥammād, *Bayʿ al kāliʿ bi al-kāliʿ*, Markaz Abhāth al-Iqtisād al-Islāmī, Jāmiʿat al-Malik ʿAbdul Azīz, Jeddah, Saudi Arabia, 1986, pp. 28–29.

³⁸ ʿAbd al-Wahhāb abū Sulaimān, “ʿAqd al-Tawrīd.” Unpublished paper. In the forthcoming *Mawsūʿat al-Muʿāmalāt al-fiqhiyyah*, Islamic Fiqh Academy, OIC Jeddah, as quoted by Vogel and Hayes, p. 87.

Ḥammād and Abū Sulaimān, both in Arabic and English works.³⁹ However, a close look at the data adopted in this work, especially in the area of derivatives and futures trading, reveals that the authors confined themselves to limited sources of information.

Regarding forward contracts, the study maintains that *salam* contract is the closest Islamic approximation to the conventional forward contract.⁴⁰ With regard to futures contracts, the study concluded that there is no direct equivalent of futures contracts in Islamic finance. In addition to the already discussed problem of forward contracts, namely the postponement of both the price of the goods and the payment, futures require a daily marking to market, which is also forbidden in Islam. But the study did not exclude the possibility of a kind of Islamic futures based on *salam*.⁴¹ Here again some proposals have been made based on parallel *salam* whose legality will be ascertained in subsequent chapters. As in the case of our review of the studies on forward and futures contracts, the present study will review the institutional studies in options, followed by the individual studies.

Options Contracts

There are several institutional as well as individual studies addressing the legality of options contracts in a similar line to that adopted in forward and futures contracts.

³⁹ See, for instance, Kamālī's study, "Islamic Commercial Law: An Analysis of Futures," *American Journal of Islamic and Social Sciences*, vol. 13, Summer 1996, no. 2, pp. 201–203; and it seems that the authors are aware of his opinion on the issue. As Kamālī mentioned in the acknowledgement of his manuscript, *Islamic Commercial Law: An Analysis of Futures and Options*, Research Center International Islamic University, he was invited by Vogel to deliver a lecture on Futures from the Islamic point of view at Harvard University. Moreover, many other scholars' writings in Arabic have argued against this maxim, such as al-Ḍarīr in his book *al-Gharar wa 'Atharuhū fi al-'Uqūd*, Dallāh al-Barakah Jeddah, 1995, pp. 329–336; Aḥmad Ḥassan in his book *'Amal Sharikāt al-Istithmār al-Islāmiyyah fi al-Aswāq al-'Ālamiyyah*, pp. 286–321; Rafīq al-Maṣri, in his book *al-Jamī' fi Uṣul al-Ribā*, pp. 339–347; and Majd al-Dīn Azzām in his reply to the fatwā of the *Sharī'ah* adviser of Kuwait Finance House; see *al-Fatāwā al-Sharīyyah fi-al-Masā'il al-Iqtisādiyyah* pp. 539–545 and 'Isāwī Aḥmad Isawī, "Bay' al-Dayn wa Naqlihī," *Majallat al-Azhar*, Cairo, no. 2, 1956, pp. 168–170.

⁴⁰ *Ibid.*, p. 223.

⁴¹ *Ibid.*, pp. 225–226.

Institutional Studies

As mentioned earlier, the Islamic Fiqh Academy addressed the issue of derivatives through El-Gārī's paper in which he performed an analysis on options. He compared options with *khiyār al-sharṭ*, *salam*, and *bay' al-'arbūn* and concluded that:

- There is an apparent difference between *khiyār al-sharṭ* and options because options contracts are traded separately from the contract of the underlying commodity while in *khiyār al-sharṭ* the option is part of the contract of the commodity traded. Therefore, in options there is a combination of two contracts, namely, the premium and the price of the underlying asset while *khiyār al-sharṭ* is just a single contract.
- Options are also different from *salam*. The option contract is traded separately from the contract of the underlying commodity, which is not the case in *salam*.
- Next, he compared options with *bay' al-'arbūn* and concluded that the paid price in *bay' al-'arbūn* is part of the whole price of the commodity, while in options it is totally separated.

El-Gārī also makes the assumption of considering an options contract as a combination of a promise that is followed by a contract. But he raised the legality of selling a promise and gave a negative answer. Furthermore, he added that options contracts combine two contracts in a single transaction, which is prohibited in Islam. Finally, he discussed the legality of selling just a "right," as it is in the case of a premium in options, and he concluded that although Islam allows the sale of some "rights," the right in options is totally different from those already approved by Muslim jurists.

El-Gārī concluded that, "despite the fact this transaction has some characteristics of a sale, it is harmful in most cases and the objective of the participants in such a market is similar to that of gamblers who act on the basis of luck and risk. Furthermore, it involves high-risk or *gharar fāhish* and the motive behind it is risk itself."⁴²

However, El-Gārī's harsh position regarding options seems to have changed drastically a few years later. Thus, in his article "Toward an

⁴² Mohamed Ali El-Gārī, "al-Aswāq al-Mūliyyah," *Majallat Majma' al-Fiqh al-Islāmi*, 1990, no. 6, vol. 2, pp. 1610–1617.

Islamic Stock Market,” he rebutted the criticisms raised by some that options do not serve any economic purpose, but are only a method of gambling. He pointed out that “the possibility of using this type of contract for gambling purposes is not ruled out; however, this element does not accompany the concept of options by necessity.”⁴³ In addition, he suggested some essential measures to avoid the element of gambling. El-Gārī has taken a very similar position in his article published as part of the *Encyclopaedia of Islamic Banking and Insurance*.⁴⁴

The issue was discussed again in the seventh Islamic Fiqh Academy meeting and a resolution was adopted. The resolution stated that “options contracts as traded nowadays in the international market do not fall under the purview of any one of the nominated contracts. They are new types of contracts and since the subject matter in these types of contract is not *māl* (wealth), *manfaʿah* (usufruct), or *ḥaq māli* (right related to property) which could be legally exchanged, then, they are illegal types of contract and their trading is prohibited.”

The different papers on options presented at the Academy seventh session followed almost the same line of discussion that they received from the Academy’s secretariat. Thus, they touched on the definition of options, their position in the general theory of contracts, their relation with other types of contracts, especially *bayʿ al-ʿarbūn*, *salam*, *khiyār al-shart*, sale through description, gift, and the possibility of buying and selling an absolute “right.” This was followed by two separate discussion sessions on the two topics.

A close look at the different papers might explain the different rulings in the resolution. For instance, some of the scholars who delivered papers on the issue passed a prejudgment on options prior to any discussion or deliberation on the issue. Sheikh al-Salami, for example, said “from their introduction and objectives, options would not accept any Islamic modification. Moreover, any modification to make these types of contracts [come] in[to] compliance with *sharīʿah* principles could be considered only if it is possible to implement them. However, options in their market do not accept any alteration and the Islamic world is

⁴³ Mohamed Ali El-Gārī, “Toward an Islamic Stock Market, *Islamic Economics Studies*, vol. 1, no. 1, December 1993, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, pp. 1–20.

⁴⁴ Institute of Islamic Banking and Insurance, *Encyclopaedia of Islamic Banking and Insurance*, London, 1995, pp. 164–173.

not in need of these contracts in its economy.”⁴⁵ For his part, al-Ḍarīr in the first sentence of his study on options said, “This is a new type of contract and it is an illegal contract. . . .” He concluded, saying “There is no need to look for alternatives to these transactions from the Islamic point of view because it does not lead to any significant public interest which needs to be safeguarded.”⁴⁶

It is worth noting that a great deal of Islamic law is based on *maṣlahah* (public interest) and need. However, it seems that the benefits of options, as tools of risk management, had not been very well explained to these jurists and scholars by the Muslim economists associated with the Islamic *Fiqh* Academy. Accordingly, some of these jurists concluded that the Muslim economy is not in need of these contracts.

It is clear that this attitude of prejudgment would not be of much help in reaching a systematic and fair conclusion. Perhaps because of the misgivings, the participants did not even make the effort to modify these new types of contract or to look for an Islamic alternative. Moreover, to think that options have no benefit at all is to deny an internationally recognized reality.⁴⁷ Still, it is possible to argue that despite their benefits, options may involve high risk and harm, and, therefore, should not be allowed in Islamic finance in their present form. But to exclude them altogether is out of touch with reality. If there were no benefits in options, one might ask why the issue has been raised from an Islamic point of view by Muslim economists and financial institutions, such as the Islamic Development Bank. Moreover, it should be taken into consideration that the major part of the Muslim world economy is based on commodities such as petroleum, cotton, palm oil, rubber, tin, etc., which are traded in futures markets whether in relation to forward, futures, or options contracts.

Another example of these prohibitive attitudes, which may be behind the Academy’s resolution, is seen when Sheikh al-Salāmī maintained in his paper that options are just an expansion of gambling and new ways to gain money without effort.⁴⁸ This claim was also made by some other

⁴⁵ Mohammad Mukhtār al-Salāmī, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 241.

⁴⁶ Ṣiddīq al-Ḍarīr, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 271.

⁴⁷ See chapter 10 on the economic benefits of options.

⁴⁸ Mohammad Mukhtār al-Salāmī, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 235.

discussants. However, when Sheikh ‘Ali al-Taskhīrī warned against labeling these contracts as gambling contracts without a strong basis, Sheikh al-Salāmī revised his initial position, saying “Yes, sometimes they may involve gambling but sometimes they are a kind of buying and selling with the intention of hedging against the risk of price fluctuation,”⁴⁹ and he cited an example of a farmer.

Individual Studies

Among those who addressed the legality of options is Kamālī. He reviewed some of the existing literature on options, addressing its shortcomings, especially that of ‘Abd al-Wahhāb Abū Sulaimān, “al-Ikhtiyārat: Dirāsah Fiqhiyyah Taḥlīliyyah Muqārānā in “*Majallat al-Buḥūth al-Fiqhiyyah al-Mu‘āṣirah*,” and that of Aḥmad Ḥassan Muḥyi al-Dīn, “*‘Amal al-Sharikāt al-Istithmār al-Islāmiyyah Fi al-Sūq al-‘Ālamiyyah*.” He compared options with *khiyār al-sharṭ* and *bay‘ al-‘arbūn*. He also discussed the issue of whether it is lawful to charge a fee for granting an option and whether an option could be bought and sold as a valuable instrument in its own right. He concluded thus:

This analysis is affirmative not only on the parties’ freedom to insert stipulations in contracts but also that a monetary compensation or a fee may be asked by one who grants an option or a privilege to the other. If the seller is entitled to stipulate for a security deposit or a pawn then it is a mere extension of the same logic that he may charge the buyer and impose a fee or compensation in respect of such options and stipulations that are to the latter’s advantage. When the buyer, for example, stipulates that he will ratify or revoke the contract within a week or a month, this may well prove to be costly to the seller and he may therefore charge a fee/compensation for granting the option. We thus conclude that options may carry a premium and [there]should be, therefore, no objection to this.⁵⁰

However, this argument will solve the problem only if we consider the premium as part of the whole price of the underlying commodity and that it cannot be traded separately. Still, although Kamālī’s argument here is similar to that of the Ḥanbalī school in allowing *bay‘ al-‘arbūn*, and it will really fulfill some of the benefits of options, the question

⁴⁹ *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, pp. 581–584.

⁵⁰ Mohammad Hāshim Kamālī, *Islamic Commercial law: an Analysis of Futures and Options* (unpublished manuscript), Research Center International Islamic University, Malaysia, pp. 356–357.

that remains is the following: is it permissible to trade such an option separately from the underlying commodity? This is what Kamālī's work did not discuss and the present study proposes to address it in detail.

Moreover, this argument limits such a benefit to the seller, and it may be asked if it is possible for the buyer to make a similar stipulation. And only at that stage, could we state that at least the simple types of options, namely put and call options, could be accommodated in Islamic law. It should be noted that the classical scholars did not discuss such things in their works. However, the door is not totally closed. Thus, we believe that the issue of buying and selling just a "right," like the one in options, needs more investigation, especially when we find that it was the main grounds for the rejection of options by the Islamic *Fiqh* Academy and the different workshops jointly held with the Islamic Development Bank.

On the other hand, despite the fact that Kamālī considers *bay' al-'arbūn* as closely resembling options, especially in respect to options that relate to the payment of a nonrefundable premium, and in the sense that both can be used as risk reduction strategies, Kamālī preferred to accommodate options through *khiyār al-sharṭ*. He stressed that

Although *khiyār* and *'arbūn* share the same rationale and can both provide the necessary juristic support for options trading, they are nevertheless not identical and each can be utilized for different purposes. I still prefer to utilize the theory of *khiyārāt* (Islamic options) as the juridical premise for validating options. I say this not only because of the unequivocal support that is found for *khiyārāt* in the sunnah, but also because the basic concept of the option of stipulation strikes a closer note with options as a trading formula and a derivative instrument that is associated with an underlying contract.⁵¹

The present study proposes to utilize *bay' al-'arbūn* as the juridical premise for validating options, while the possibility of accommodating options through *khiyār al-sharṭ* will also be thoroughly investigated. This is because, first, *bay' al-'arbūn* is *khiyār al-sharṭ* plus the permission to buy and sell this option. Second, *bay' al-'arbūn*, as pointed out by Kamālī, closely resembles options, especially in that aspect of options that relates to the payment of a nonrefundable premium and in the sense that both can be used as risk-reduction strategies. Last, despite the fact that the legal foundation of *bay' al-'arbūn* in the

⁵¹ Ibid., pp. 369–370.

sunnah is weaker than that of *khiyār al-sharṭ*, it could be accommodated under the general theory of freedom of contract. Moreover, it has been accepted by some Companions, including ‘Umar, the second caliph, and the Ḥanbalī School of law. In addition, the Islamic *Fiqh* Academy has given its permission in its resolution no. 72(3/8)⁵² about ‘*arbūn*, which eliminates any reluctance about its permissibility and acceptance. But these arguments will be discussed later at the right place.

In conclusion, Kamālī maintained that “there is nothing inherently objectionable in granting an option, exercising it over a period of time, or charging a fee for it, and that options trading (like other varieties of trade) is permissible, (*mubāh*) and as such, it is simply an extension of the basic liberty that the Qur’ān has granted to the individual with respect to civil transactions and contracts (al-Baqarah 2:275; al-Mā’idah, 5:1). Needless to say, options trading, like all other varieties of commerce, can be distorted by malpractice and abuse and the likelihood of this is perhaps widespread in options on futures and, indeed, options over assets that involve high levels of speculative risk-taking. It is, therefore, essential that we adopt a vigilant attitude toward refining our safeguards against malpractice at all levels.⁵³

Another scholar who opted for the permissibility of options under *khiyār al-sharṭ* was Aḥmad Yussuf Sulaymān in his article “Ra’y al-Tashrī‘ al-Islāmī fi Masā’il al-Burṣah.”⁵⁴ A similar opinion was shared by Mohammad Obaidullah who discussed *khiyār al-sharṭ* in different articles⁵⁵ and considered it as the Islamic alternative to conventional options and a tool of risk management. Moreover, in his article “*istijrār*: A Product of Islamic Financial Engineering,”⁵⁶ Obaidullah compared *istijrār* with similar products of conventional financial engineering and made a case for its use.

⁵² See *Majallat Majamā‘ al-Fiqh al-Islāmī*, no. 8, vol. 1, p. 641.

⁵³ Mohammad Hāshim Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, pp. 270–271.

⁵⁴ *Al-Mawsū‘ah ‘al-‘Ilmiyyah wa al-‘Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Banks, vol. 5, pp. 4244–457.

⁵⁵ Mohammed Obaidullah, “Islamic Options-Engineering Risk Management Solution,” *New Horizon*, Islamic Institute of Islamic Banks, London, May 1998, pp. 6–9 and “Financial Engineering with Options,” *Islamic Economic Studies*, Islamic Development Bank, Jeddah, Saudi Arabia, vol. 6, no. 1, November 1998, pp. 73–103.

⁵⁶ Mohammed Obaidullah, “*Istijrār*: A Product of Islamic Financial Engineering,” *New Horizon*, Islamic Institute of Islamic Banks, London, October 1997, pp. 3–8.

On the other hand, Aḥmad Muḥyī al-Dīn in his book, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*,⁵⁷ claimed that options are illegal because they contradict the general principles of Islamic commercial law. In addition, they do not fall within the purview of *khiyār al-sharṭ* or its objectives. Moreover, they contradict the principle of justice since the option holder will benefit from the loss of the one who provided them. He added that such options are similar to the illegal kind of options (*al-shurūṭ al-fāsidah*) that have been rejected by all schools of law. Finally, these kinds of contract are similar to some contracts prohibited in Islam such as the combination of two contracts in a single transaction (*bayʿataini fi bayʿatin wāḥidah*).

It should be noted that none of these objections is genuine or has a strong link with the validity of options. However, we will discuss them at their proper places later. Aḥmad Ḥassan continued to maintain the same argument in his book, *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*. Aḥmad Ḥassan was also very critical of speculation, but acknowledged the need for market players who are looking for price differentials to ensure liquidity in the market.⁵⁸

On the other hand, Obiyathullah's paper entitled "Derivative Instruments and Islamic Finance: Thoughts for Reconsideration" addressed the issue of derivative instruments, their evolution, their benefits, and makes a case as to why they are needed. In addition, he discussed *salam* and *istijrār* as Islamic financial instruments with features of derivative instruments. He limited the scope of his article, saying "The objective of this paper is not to reevaluate these instruments in the light of the *Sharīʿah*, nor is it intended as a critical examination of the juridical works of *fuqahāʾ* (Sharīʿah scholars). What is intended here is to provide a deeper understanding and an appreciation of these instruments: how they evolved, why they are needed, their diversity of

⁵⁷ Aḥmad Ḥassan Muḥyī al-Dīn, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

⁵⁸ Aḥmad Ḥassan Muḥyī al-Dīn, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

use, and the serious handicap that could be posed to Islamic businesses from ignoring them.”⁵⁹

Vogel’s and Hays’ study explored the possibility of options through *khiyār al-sharṭ* and *bayʿ al-ʿarbūn*. It concluded that *khiyār al-sharṭ* or the stipulation of an option has little apparent significance for the creation of Islamically valid derivatives, since the party giving the option cannot be compensated for doing so; thus, the option right itself is not paid for. Its significance is rather a vital analogy, and a background set of rules and principles for *ʿarbūn*.⁶⁰ Regarding *ʿarbūn* itself, the study concluded that of all Islamic contracts, *ʿarbūn* offers the closest analogy to options. However, they acknowledged that classical law gives little hope for the approval of the option contract. Rather, it poses a series of objections, of which the following are the most important.

- An option requires payment for something that is an intangible “right,” not property (*māl*) in the usual sense (i.e., tangible goods or a utility taken from a tangible good), for which compensation alone can be demanded. This is one basis for the objection of some scholars that the option price is “unearned.” It is also the position taken by the OIC Academy in declaring the illegality of an option contract.
- An option arguably involves gambling. In practice, only one party can gain from the contract, while the other must lose. Whether a party will gain or lose depends on the unknown futures market price. In most actual option contracts, moreover, the parties have no intention of taking delivery, but only of liquidating their contracts against the price differentials. In every lawful Islamic sale, on the other hand, the parties fix their exchange fully at the time of the conclusion of the contract, and at least one if not all the countervalues are presently owed, even if not immediately paid for.
- An option incorporates the idea of a future sale, which is itself impossible under classical law.
- If the option is in currency, not even forward sales are allowed since currencies may be exchanged only at the spot.

⁵⁹ Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration”, Unpublished Paper, International Islamic University, Malaysia, November, 1997, p. 7.

⁶⁰ Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance Religion, Risk, and Return*, p. 156.

- The price of an option compensates for lost opportunity. Opportunity costs are by definition conjectural, involving sales that do not occur. Damages in Islamic law do not include conjectural losses.
- Options may involve selling what one does not own.

For all these reasons, unless justifiable as *'arbūn* or by analogy with *'arbūn*, the option contract in conventional form is unlikely to be accepted.⁶¹ It should be noted that these objections are mostly those pointed out by the participants in the Islamic *Fiqh* Academy session on options. However, neither Vogel and Hayes's study nor that of the Islamic *Fiqh* Academy went beyond that by discussing the genuine grounds of these objections in Islamic law. Nonetheless, we do believe that many of these objections, if not all of them, could be reversed if a thorough investigation is made.

It should be noted, however, that Vogel and Hayes's study provides some good suggestions as to how to develop Islamic options, the legal grounds of which will be discussed in the relevant chapter.

⁶¹ Ibid., pp. 264–5.

CHAPTER TWO

THE FORWARD COMMODITIES MARKET

A forward contract is an agreement to exchange assets in the future at a predetermined price. It plays a vital role in the Western financial markets and serves as the basic building block for more advanced and sophisticated financial instruments. The primary function of the forward market is to provide a vehicle to hedge against unexpected and undesirable price fluctuations. The forward market directly affects the spot market as it also offers arbitrage and speculation opportunities. Forward markets also serve the purpose of “price discovery”—the process of determining the equilibrium prices that reflect current and positive demands for current and prospective supplies, and making these prices visible to all.¹

The forward contracts in commodities are the simplest type of derivatives. In such a contract the parties could be a producer who promises to supply the product and a consumer who needs the product. Forward contracts are common in merchandise or commodities trading. Without them, business trade and planning would be greatly hindered. If a small baking company could not order flour in advance for its immediate needs, for example, it would have to buy a large quantity at a prevailing price and store it for future use. There would be uncertainty about what the price would be when the next order is placed. The miller will have a more difficult task in planning how much flour to produce without orders in hand, and shortages would be more likely to occur.²

To see how a typical forward contract works, let us examine a simple example of a cocoa farmer (producer) and a confectioner who needs cocoa for his product (consumer). To simplify matters, let us say the farmer has planted cocoa and expects to harvest 120 tons of cocoa in six months. The confectioner, on the other hand, has cocoa in his

¹ Philippe Jorion and Marcos De Silva, *The Importance of Derivatives Securities Markets to Modern Finance*, Catalyst Institute (Chicago: Catalyst Institute), p. 222.

² Anthony F. Herbst, *Commodity Futures Markets, Methods of Analysis, and Management of Risk*, John Wiley and Sons, United States, 1986, p. 3.

inventory to last him for the next six months but will need to replenish his inventory in six months with 120 tons. Though simplified, this is a very common business situation. We have a producer who will have product available at a future date and a consumer who will need the product in the future. Clearly, both parties face risk, essentially price risk. While the farmer will be fearful of a fall in the spot price of cocoa between now and six months from now, the confectioner will be susceptible to an increase in the spot price. Thus, both parties face risk, but in the opposite direction. It would be logical for both parties to meet, negotiate, and agree on a price at which the transaction can be carried out in six months. Once the terms are formalized and documented, we have a forward contract accruing to both parties. Both parties, because of the forward contract, have eliminated all price risk. The farmer now knows the price he will receive for his cocoa regardless of what happens to cocoa prices over the six months. The confectioner too has eliminated price risk since he will only have to pay the agreed upon price, regardless of spot prices in the next six months. There is a second benefit to this. Since both parties have “locked-in” their price/cost, they would be in a much better position to plan their business activities. For example, the confectioner can confidently quote to his customers the price at which he delivers them products in the future. This would not have been possible if he were uncertain about his input price. The benefits of a forward contract, therefore, are often more than merely hedging price risk.³

Economic Benefits of the Forward Contract

Some *shari‘ah* scholars have argued in favor of this contract. ‘Abd al-Wahāb Abū Sulaimān, for instance, said “The need for this contract is not a need confined to a specific nation, it is a need for all nations around the globe whatever their status of civilization, developed or developing. The principle in Islamic law is that the general need could be considered as necessity (*al-ḥājah idhā ‘ammat kānat ka al-ḍarūrah*).”⁴

³ See Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,” p. 3.

⁴ ‘Abd al-Wahāb Abū Sulaimān ‘Aqd al-Tawrīd Dirāsh Fiqhiyyah Taḥlīliyyah” paper presented to the twelfth session of the Islamic Fiqh Academy, Rabat, Morocco, p. 7.

Similarly, Ḥasan al-Jawāhirī maintained that the forward contract used by companies and governments to secure the supply and export of goods becomes a necessity of modern transactions.⁵

Sheikh Mukhtār al-Salāmī also comes out very strongly in favor of this contract after giving some examples regarding its application, and arguing that the need for it is the result of the technological advancements in this world and that the Islamic world has no other alternative but to follow. It is the necessity of modern civilization which has shortened distances between places and made it necessary for any nation which wants to survive to follow suit. If we are going to make it compulsory for companies and industries to advance the payment of every transaction they want to conclude, as it is in the *salam* contract, we are forcing them not to produce and if we are making it compulsory for them not to sell what they have not manufactured yet, we are leading them to bankruptcy. Moreover, rejecting this contract will create hardship and *ḥaraj* (difficulty and hardship) to Muslims while what is important is to protect the *maṣlahah* (public interest) of the *ummah* (community) and its property.⁶

It should be noted here that despite his positive and strong analysis of different principles related to futures trading, Ibn Taymiyyah opposed the deferment of both countervalues (assets) in a contract or the forward contract. According to him, such a contract has no benefit and the *dhimmah* (liability, responsibility) of the two parties will be made liable for nothing. The objective of the contract, Ibn Taymiyyah argues, is to make delivery and since there is no delivery in this contract, the ultimate objective of the contract is not fulfilled.⁷ Ibn Qayyim followed the argument of his teacher, and reached the same conclusion.⁸ Refuting this argument, Sheikh al-Ḍarīr said:

The claim that there is no benefit in such a contract is unacceptable. The buyer will own the subject matter of the contract and the seller will own the price and the deferment of taking possession will not render the contract without benefit. Moreover, a sane or rational person will not enter

⁵ Ḥasan al-Jawāhirī, “Uqūd al-Tawrīd wa al-Munāqaṣāt” paper presented at the twelfth session of the Islamic Fiqh Academy, Rabat, Morocco, p. 3.

⁶ See Mukhtar al-Salāmī, “Ta’jīl al-Badalayn fi al-‘Uqūd,” paper presented in Nadwāt al-Barakah al-Tāsīa’h ‘asharah lil iqtisād al-Islāmī, Makkah al-Mukarramah, 2–3 December 2000, p. 5.

⁷ Ibn Taymiyyah, *Nazariyyat al-‘Aqd*, p. 235.

⁸ Ibn Qayyim, *l’lām al-Muwaqq’in an Rab al-‘Ālamīn*, vol. 3, p. 9.

into a contract without having interest in it. Therefore, if the two parties have no real interest in this contract they would not have concluded it from the beginning.⁹

Moreover, as Aḥmad Ḥassan rightly pointed out, it is likely that there was no benefit for such contracts at the time of Ibn Taimiyyah and Ibn Qayyim. They rejected this contract only on these grounds¹⁰ and not on any other genuine legal grounds. We have already shown that this contract does have benefits. Aḥmad Ḥassan stressed that the global material development brought about new economic transactions, which were unknown to early Muslim jurists. Therefore, the trend of judging such a contract as illegal without any strong legal basis is against the objectives of the *sharī'ah*. We do believe that any contract in Islamic law should fulfill the following conditions to be considered as legal:

1. It should not contradict a genuine *naṣ* (*text*).
2. It should not go against the general principles of *mu'āmalāt*. (Islamic Commercial law)
3. It should not involve a clear harm.

However, none of these three conditions is present in the forward contract. Therefore, it is a valid contract.¹¹ However in his book *'Aswāq al-'Awrāq al-Māliyyah*, and for fear that the forward contracts may be used for speculative purposes, Aḥmad Ḥassan reversed his initial position and concluded that it might be considered as an illegal contract.¹² Ironically, he allowed such a contract to be used only for import and export activities. He failed to rebut the strong arguments he advanced in his previous book for the legality of this contract. Moreover, the argument that these kinds of contract may be used for speculative purposes may not be acceptable, especially in the commodity and share markets. Hence, it could be used for that purpose in the currency, interest rate, and stock index markets. Then, this possibility should not be applied to other areas without a strong basis. Moreover, since interest rate futures

⁹ al-Ḍarīr, *al-Gharar wa Atharuhu fi al-'Uqūd*, p. 316.

¹⁰ Aḥmad Ḥassan Muhyī al-Dīn, *'Amal Sharikāt al-Istithmār al-Islāmiyyah fi al-'Aswāq al-'Ālamīyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, p. 320.

¹¹ *Ibid.*, pp. 320–321.

¹² Aḥmad Ḥassan Muhyī al-Dīn, *'Aswāq al-'Awrāq al-Māliyyah wa Atharuha al-Inmā'iyyah fi al-Iqtisād al-Islāmī*, p. 323.

contracts and stock index futures contracts are excluded from the beginning from the Islamic alternative, there are no grounds for objection.

Isāwī Aḥmad also refuted the claim that there is no benefit in the forward contract. It is not acceptable because traders and manufacturers always compete in trading their products. Thus, if a manufacturer would like to guarantee the sale of his product, he will enter into an agreement with a buyer on the condition that he will receive the price later when the commodity sold is presented. The trader on his part may be in need of a specific commodity but he has no money for the time being. If he has to wait until he gets the money, another trader may take the commodity in question before him. Therefore, to avoid this risk he has to enter into the deal with the condition that he will pay the price at the time he receives the goods. In such a deal both payment for and delivery of the commodity have been deferred but there is a real interest involved. Thus, the postponement of both payment and commodity is lawful except in the case of currency trading. Moreover, we have some cases in which both countervalues have been deferred but the transaction is still considered valid in Islamic law, such as the case of *ijārah* (lease) and *ju'ālah*. In both cases, a person may request another person to do something for him in exchange for a charge which will be paid to him after the job has been accomplished. Therefore, the contract in which both countervalues have been deferred (the forward contract) is a legal contract if it does not involve *ribā* (interest) or *gharar*¹³ (risk-taking). Similar objections to Ibn Taimiyyah's opinion are advanced by Sheikh Mukhtār al-Salāmī,¹⁴ Sheikh Aḥmad 'Ali 'Abd Allāh,¹⁵ and Sheikh Ḥasan al-Jawāhirī.¹⁶

However, the forward contract as a trading instrument in its actual form has no exact counterpart in Islamic law. Some scholars have drawn a similarity between the forward contract and *bay' al-salam* on the one hand and *bay' al-istiṣnā'* on the other. Furthermore, some have tried to establish the legality of this contract under *bay' al-ṣifah* (sale by description). Therefore, we have to look into the points of similarity and difference between *salam* (contract of future sale) and *istiṣnā'* on

¹³ Isawi Ahmad, "Bay' al-Dayn wa Naqlihi," pp. 169–170.

¹⁴ See Mukhtār al-Salāmī, "Ta'jil al-Badalain fi al-'Uqūd," paper presented in Nadwat al-Barakah al-Tāsia'h 'asharah lil iqtisād al-Islāmī, Makkah al-Mukarramah, 2–3 December 2000, p. 3.

¹⁵ Aḥmad 'Ali 'Abd Allāh, "al-Bay' 'alā al-Ṣifah," paper presented in Nadwat Bank al-Shamāl lita'sil al-'Amal al-Maṣrifī, 20–21 June, 1997, Sudan, p. 4.

¹⁶ Ḥasan al-Jawāhirī, "Uqūd al-Tawrīd wa al-Munāqasha't," p. 5.

one hand, and the modern forward contract on the other. Meanwhile, if it could be accommodated under the category *bay' al-ṣifah* then what are the similarities and differences between the two contracts? However, if we consider the forward contract as a new type of contract, then, we need to study it within the general principles of Islamic commercial law. Moreover, we have to look into the authenticity of the arguments posed against it, such as the claim that it is a kind of *bay' al-kāli' bi al-kāli'*, that is, the sale of what one does not possess, the sale of *mādūm* (non-existent), and the claim that there is no benefit in such a contract.

Salam and the Forward Contract

Salam is the closest, among the contracts named in Islamic law, to the conventional forward contract. Some scholars have considered it as the Islamic alternative to the forward contract. Thus, Sudin Haron said:

Forward markets do exist in Islamic financial system but only on a limited scale. Futures markets, however, have not been established in Islamic financial system. In case of forward markets for money there is a divergence of opinion pertaining to the legality of such transaction from the point of view of *sharī'ah*... Forward markets for commodities are allowed by *shari'ah* under the principle of *bay' al-salam* (an advance purchase) and *istiṣnā'* (a contract to manufacture).¹⁷

However, it seems that to consider *bay' al-salam* as the typical Islamic alternative to the modern type of forward contract in commodities would not be totally correct without resolving some controversial issues. Thus, one of the outstanding issues here is that in *bay' al-salam* full payment at the time of agreement is a requirement according to the majority of Muslim jurists, which is not the case in the forward contract. Therefore, to accommodate the forward contract in Islamic finance such an issue should be addressed. This study will attempt to elaborate on the matter. Another issue of concern related to *bay' al-salam* and the forward contract is the claim made by many scholars that *bay' al-salam* is accepted in Islamic law but not in accordance to the norms; rather, its acceptance is considered to be an exception. Therefore, it is not possible to make an analogy between *salam* and any new contract.

¹⁷ Sudin Haron and Bala Shanmugan, *Islamic Banking System Concept and Application*, Pelanduk Publications, Kuala Lumpur, 1997, p. 180.

This issue also needs to be addressed in connection with the legality of the forward contract.

Zamīr Iqbāl considered *bay' al-salam* to be the closest substitute for the forward contract. He acknowledged that *bay' al-salam* is not practiced in the financial market for two reasons: first, compared to the western forward contract, *bay' al-salam* requires full payment at the time of agreement. Second, since interest is incorporated in the determination of the forward contract price, it is synonymous with paying or receiving interest. The point in question is whether an increase with deferred delivery is justified or not and, if such an increase is allowed, does it result in dealing with interest (*ribā*)? Zamīr Iqbāl concluded that a forward contract may not incorporate the element of interest as it is prohibited by Islam.¹⁸

However, it should be noted that the issue as to whether an increase in price with deferred delivery will be synonymous with paying or receiving interest does not arise in the forward contract at all. Moreover, several Islamic institutions have ruled for its legality.¹⁹

Thus, we may submit that the issues related to *salam* in connection to the forward contract which need to be discussed are, first, the issue of full payment at the time of agreement in *salam* and, second, the possibility of drawing an analogy with *salam* if we consider it in line with *qiyās* (analogy) and not against it. Still, some other issues may have a bearing on our discussion, namely, the relation between *salam* and futures trading contracts, such as the possibility of selling the *salam*-based goods before actual receipt of the parallel *salam*. However, these issues are more closely related to futures contracts than forward contracts; we are concerned here just with forward contracts. It is logical, nevertheless, to discuss briefly the important features of *salam* before proceeding to any comparison.

Definitions and Conditions of Salam

Salam is defined as “a sale or purchase of a deferred commodity for the present price (*bay' 'ājilin bi 'ājil*).”²⁰ Another definition is as follows:

¹⁸ See Zamīr Iqbāl, “Financial Innovation in Islamic Banking,” *Journal of Islamic Banking and Finance*, The International Association of Islamic Banks, Karachi (Asian Region), vol. 15, no. 2, April–June 1998, pp. 12–13.

¹⁹ See Islamic *Fiqh* Academy’s resolution no. 2, 6th session, 1990.

²⁰ Ibn ‘Abidin, *Ḥāshiyat Rad al-Muḥtār*, al-Bābī al-Ḥalabī, Cairo, 1966, p. 209.

“A transaction where two parties agree to carry out a sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid for today.”²¹ On the other hand, beside the general conditions of an ordinary sale in Islamic law, *salam* has its own conditions. Thus, based on the writing of classical Muslim scholars, and by the requirements adopted by the Islamic Fiqh Academy (Jeddah) in its ninth session, a *salam* contract must fulfill the following conditions:

1. It is necessary to precisely fix a period for the delivery of goods.
2. Quality, quantity, and place of delivery must be clearly enumerated.
3. A *salam* contract cannot be based on uniquely identified underlying assets. This means the underlying commodity cannot be based on a commodity from a particular farm/field.
4. Full payment should be made at the time of making the contract.²²

This last condition is not a point entirely agreed upon among the different schools of Islamic law and it is this condition which may prevent *salam* from playing a parallel role to the modern forward contract in the commodities market. According to the Ḥanafīs, Shaf'īīs and Ḥanbalīs payment of the principal should not be delayed beyond the time the contract is signed. Their justification for this is that delay of both commodity and principal is in fact a sale of debt for debt, which is prohibited in the *sharī'ah*.²³ Moreover, the principal must be paid in advance if the very objective of *salam* is to be fulfilled.²⁴ On the other hand, the Mālikīs disagree with regard to the permissibility of delaying the price of *salam*. Delay of payment according to them is possible as follows:

²¹ Fahīm Khān, *Islamic Futures and Their Market*, Research Paper no. 32, Islamic Research and Training Institute p. 14; also see Obiyathulla Ismath Bacha “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,” Unpublished Paper, International Islamic University Malaysia, November, 1997, p. 18.

²² Şiddīq al-Ḍarīr, “al-Salam wa Tatbiqātuhu al-Mu’āşirah,” *Majallat Majma’ al-Fiqh al-Islāmī*, ninth session, 1996, no. 9, vol. 1 p. 379–383; Nazīh Ḥammād, “al-Salam wa tatbiqātuhu al-Mu’āşirah,” *Majallat Majma’ al-Fiqh al-Islāmī*, ninth session, 1996, no. 9 vol. 1, pp. 553–555.

²³ The notion of prohibition of sale of debt for debt is widely cited as grounds to invalidate numerous kinds of transactions. However, in reality there is nothing in the *sharī'ah*, which prohibits the sale of debt for debt unless it involves *ribā* or high risk (*gharar*). The present study will dedicate a special chapter to investigate and analyze critically the arguments and opinions concerning the sale of debt for debt.

²⁴ See for instance Ibn al-Humām, *Sharḥ Faṭḥ al-Qadīr*, al-Matba’ah al-Amīriyyah, Egypt, 1937, vol. 5, p. 337; Al-Nawawī, *al-Majmū’*, vol. 9, p. 208. In Qudāmah, *al-Muḥḥanī*, vol. 4, p. 324; Ibn Ḥazm, *al-Muḥḥallā*, vol. 9, p. 109.

It is permissible to delay payment up to three days after the time of signing the contract, whether this is stipulated in the agreement between the two parties of the contract or not and whether the price is to be paid in cash or in kind. If such a delay is made according to what is agreed upon, payment should not be delayed more than three days. Some Mālikīs believe that it is permissible to delay payment for more than three days without prior agreement. On the other hand, if the payment is in kind some Mālikīs accept delay in this case, if it is for a short period. However, payment should not be delayed until the time of delivery. Another group of Mālikīs believes that if such a long delay happens, the *salam* contract would still remain valid, but the act of making a long delay is *makrūh* (disliked).²⁵

Based on the Mālikīs opinion, al-Ḍarīr did not see any problem in deferring the price of *salam* as long as it is for a period not exceeding the time of delivery of the commodity itself. He argued that the deferment by itself could not be the cause for *gharar* or prohibition but all these arguments are based on the assumption that the approval of *salam* in Islamic law was against the norms and not in line with *qiyās*.²⁶

Furthermore, it should be noted that the Mālikīs allow a similar delay in the case of land leasing. According to Imām Mālik, it is permissible to lease on the condition that the lessor receives the leased property one year after the time of agreement while the second party can pay the price ten years later.²⁷ This case also shows that deferment of both countervalues is not prohibited.

It should be noted here that the Ḥanafīs consider the payment of the price of *salam* at the time of contract as a condition for the continuation of the validity of the contract (*baqa'uhu'alā al-siḥḥa*) and not as a condition for its effectiveness (*infādhihi*) nor its validity (*siḥḥa*).²⁸ Some Shaf'īs, on the other hand, differentiate between the terms used in concluding the contract. If the contract is concluded as a *salam* or *salaf* (another name of *salam*), then the price must be paid at the time of concluding the contract. However, if the contract is concluded using

²⁵ For more details about the Mālikī's opinion see al-Ḥattab, *Mawāhib al-Jalīl li-Sharḥ Mukhtaṣar Khalīl*, Mustaphā al-Ḥalabī, vol. 4, pp. 514–517; al-Khirshī, *Sharḥ al-Khirshī 'alā Mukhtaṣar Khalīl*, Dār Ṣādir, Beirūt, vol. 5, pp. 202–203, and Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 202.

²⁶ Al-Ḍarīr, *Al-Gharar wa Atharuhu fi al-'Uqūd*, pp. 461–462.

²⁷ Imām Mālik, *al-Mudawwanah*, vol. 3, p. 370.

²⁸ Ibn 'Ābidīn, *Rad al-Muḥtār'alā al-Dur al-Muḥtār*, al-Bābī al-Ḥalabī, Cairo, vol. 4, p. 288.

the term sale rather than *salam* or *salaf*, then it is not necessary that the price should be paid immediately.²⁹ Despite the weakness of this differentiation, it does prove that the mere deferment of both counter-values is not *ḥarām* (prohibited). The following table summarizes the opinion of the major schools on the conditions of *salam*.

Table No. 1.1 Opinion of Major Schools on the Conditions of *Salam*

Item	Delivery period	Description	Type of commodity	Time of payment
1. Abu Hanifah	Must be precisely fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract
2. Imam Malik	Must be precisely fixed	Clearly enumerated	Not uniquely identified underlying asset	Could be deferred to three days or even more
3. Imam Al-Shafie	Must be precisely fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract
4. Imam Ahmad	Must be precisely fixed	Clearly enumerated	Not uniquely identified underlying asset	Full payment at the conclusion of the contract

It can be deduced from the above arguments that these scholars, especially the Mālikīs, regard the deferment of the price in *salam* as neither involving *ribā* nor *gharar*, which nullify a contract. Therefore, all these arguments about the prohibition of the deferment of both countervalues in a contract are based on the weak *ḥadīth* about *bay' al-kālī' bi al-kālī'*. One may ask why the Mālikīs, for instance, departed from the “general principles” and allowed deferment for three days? Some may argue that

²⁹ Al-Shirāzī, *al-Muhadhdhab*, Maktab al-Bābi al-Halabi, Cairo, 1976, vol. 1, p. 392.

this is not in essence a departure from the “general principles,” but just an application of the maxim *ma qārab al-shai’ yu’tā ḥukmahu*, which means whenever a case is very close to another they could be given the same rule. Therefore, a deferment of just three days may not be considered a real deferment. However, if the deferment of the price in *salam* can really lead to *ribā* or *gharar*, then could it be argued whether it is possible to allow it for one hour or one day and at best for three days? The answer is clear. *Ribā* or *gharar* cannot be allowed either for three days or more or less.

We may note here that one of the sources of misconception about the legality of deferring both countervalues is an opinion reported from Ibn ‘Abbās in connection with *āyat al-Mudāyanāh* to the effect that this verse is concerned with *salam* and since at this time, *salam* means the deferment of one of the countervalues, some scholars tried to confine the general meaning of the verse to the interpretation of Ibn ‘Abbās while others have a somewhat more liberal approach.³⁰ After analyzing the different arguments on the issue, Kamālī maintained that the ‘Ulamā’ (Shari’ah scholars) have held different views with regard to their interpretation of the word *dayn*. While some have confined *dayn* (debt) to certain types of debt, others have applied it generally to all deferred liability transactions that can fall within its broad meaning. The Qur’ān has evidently not specified the general meaning of *dayn* or *tadāyantun* (debt or debt exchange) and there is no compelling evidence to warrant a departure from this position. The preferred view would thus appear to be that the general language of the text should convey its general and unqualified meaning. Even if we admit Ibn ‘Abbās’s interpretation, it may be said that it was based on the occasion of revelation (*sha’n al-nuzūl*) of the *ayah*. According to the general rules of *uṣūl al-fiqh*, the *sha’n al-nuzūl* (the occasion of revelation) of a text may be specific but that does not necessarily restrict the general purport and ruling of the text.

Kamālī continues his argument concluding that even if the text is revealed concerning *salam*, the language of the text is general and applies to all debts, which would imply the basic legality of deferred transactions in all its varieties in the *shari’ah*, provided, of course, that

³⁰ For more detail, see chapter 6 on the sale of debt for debt.

none of the principles of the Qurʾān and sunnah on such other themes as usury, gambling, and *gharar* are violated.³¹

Another misconception related to *salam* is the claim that it is allowed against the *qiyās* and the norms of Islamic law. This is because it is the sale of what one does not possess and the sale of the nonexistent. Therefore, it involves *gharar*. However, since there is a specific *ḥadīth* from the Prophet about its legality it could be deduced that it is allowed as an exception.³²

However, this argument is rebutted by some classical scholars, such as Ibn Taymiyyah, Ibn Qayyim, and Ibn Ḥazm as well as some prominent contemporary Muslim scholars. Before giving the legal arguments it is appropriate to mention the relevance of *salam* to our discussion on forward trading. Since *salam* is the closest contract approved or permitted by the explicit sunnah of the Prophet, we are in need of extending this permissibility to the modern type of forward contract by way of *qiyās* or analogy. However, such *qiyās* would be impossible if we consider the permissibility of *salam* as an exception and against the norm. For a valid analogy, according to the commonly agreed principle of Islamic jurisprudence, the *ʿasl* or the principle should not be allowed by way of exception.³³ Therefore, any analogy with *salam* in this regard will be in violation of this principle.

In refuting the claim that *salam* is admitted against the norms of the *sharīʿah* or against *qiyās* al-Ḍarīr, for instance, said: “The right interpretation here is the one advocated by Ibn Taymiyyah and Ibn Qayyim. According to them, there is nothing in the *sharīʿah* which is against *qiyās*. Moreover, everything which is supposed to be against *qiyās* is in fact inseparable from one of two things: either the *qiyās* or analogy itself is not valid, or there is no textual evidence to prove that the rule under discussion is from the *sharīʿah*, because a genuine *qiyās* represents the justice for which Allah (s.w.t.) has sent His Messenger. Therefore, there is nothing in the *sharīʿah* which contradicts a genuine *qiyās*.” Based on this principle, al-Ḍarīr added that it could be concluded that *salam* is in line with a *qiyās*, and the *qiyās* upon which

³¹ See Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, p. 255.

³² See, for instance, Al-ʿAynī, *ʿUmdat al-Qārī Sharḥ Saḥīḥ al-Bukhārī*, vol. 12, pp. 61–63; Al-Shawkānī, *Nayl al-Awtār*, vol. 5, p. 239.

³³ *Ibid.*, vol. 5, p. 235.

some scholars rely to declare *salam* to be against the norm is a *fāsīd* (imperfect) *qiyās*.³⁴ Then he quoted Ibn Qayyim's arguments against the claim that *salam* is a kind of *bay' al-m'adūm*, the sale of what one does not possess and therefore a kind of *gharar*. However, since we are going to discuss these kinds of sales in relation to futures trading in general in separate sections, we will defer our elaboration on these issues to a later discussion. Nevertheless, Ibn Qayyim's conclusion is that *salam* is in accordance with *qiyās*, public interest, and the most complete and just legal principles.³⁵ Ibn Ḥajar³⁶ and al-'Izz Ibn 'Abd al-Salām³⁷ also advocated a similar opinion. Some contemporary scholars such as Nazih Ḥammād³⁸ and Ajil Jāsīm al-Nashmī³⁹ also endorsed the idea that *salam* is in line with *qiyās* and not against it.

Thus, we conclude that the condition that the price of *salam* should be delivered at the time of the conclusion of the contract is not based on the fear of *ribā* or *gharar* as we have seen in the Mālikīs' attitude. This stand was endorsed and extended by modern Muslim jurists such as al-Ḍarīr, who maintained that it is legal to defer the price for a short period (not necessarily three days) but it should be paid before the commodity is delivered.⁴⁰ Yet, the classical scholars may have introduced this condition in line with the nature of *salam* where the farmer would be usually in need of the money, from the beginning of the transaction to finance his agriculture and not because it is part and parcel of the validity of *salam*. More interestingly, Ibn Ḥajar in his definition of *salam* said "It is the sale of something prescribed in the *dhimma*."⁴¹ Then, he added that the phrase "On condition that the price be paid at the spot is questionable because it is not an integral part of the nature of *salam* (*laisa dākhilan fi ḥaqīqatīhi*)."⁴²

³⁴ Ṣiddīq al-Ḍarīr, "al-Salam wa Tatbiqātuḥu al-Mu'āṣirah," pp. 379–383.

³⁵ Ibn Qayyim, *Ilām al-Muwaqq'īn an Rab al-'Ālamīn*, vol. 1, p. 350.

³⁶ Ibn Ḥajar, *Fath al-Bārī*, Maktabat al-Kulliyāt al-Azhariyyah, vol. 9, p. 305.

³⁷ Izz Al-Dīn Ibn 'Abd al-Salām, *Qawā'id al-Aḥkām fi Masālih al-Anām*, Maktabat al-Kulliyāt al-Azhariyyah, Cairo, 1968, vol. 2, pp. 111–112.

³⁸ Nazih Ḥammād, "al-Salam wa taṭbiqātuḥu al-Mu'āṣirah," pp. 553–555.

³⁹ Majma' al-Fiqh al-Islāmī, *Majallat Majma' al-Fiqh al-Islāmī* (discussions about *salam*) ninth session, 1996, no. 9, vol. 1, p. 643.

⁴⁰ al-Ḍarīr, *Al-Gharar wa 'Atharūḥu fi al-'Uqūd*, p. 461.

⁴¹ It is the equivalent of personality in positive law receptacles for the capacity for acquisition.

⁴² Ibn Ḥajar, *Fath al-Bārī*, Maktab al-Kulliyat al-Azhariyyah, Cairo, 1978, vol. 9, p. 303.

This proposition is also confirmed by the Mālikī insistence that the maxim *ma qārab al-shai' yu'tā ḥukmahu* which means that whenever a case is very close to another they could be given the same rule could not be applied in currency exchange because it will lead directly to *ribā*. Thus, Ibn 'Abd al-Bar maintained that even a delay of one hour or just the disappearance of one of the contracting parties from the session of contract is not permissible.⁴³

It is worth noting that the Islamic fiqh Academy in its resolution regarding *salam* has opted for the Mālikī opinion that the price of *salam* could be delayed for three days.

To summarize the implications of delaying the price of *salam* for three days according to the permissibility or not of the forward contract we would like to point out to the following:

- There is no explicit *ḥadīth* (*naṣ*) which states that the price of *salam* must be paid at the formation of the *salam* contract.
- Muslim scholars relied on the '*ḥadīth*' of *bay' al-kāli' bi al-kāli'*, which prohibits the sale of debt for debt, to stipulate it as a condition in *salam* that the price of *salam* must be paid in advance to avoid the possibility of *salam* becoming a kind sale of debt for debt. However, it should be noted that the *ḥadīth* of *bay' al-kāli' bi al-kāli'* is not directly connected to *salam*. It is about a general principle extended through jurisprudential analysis to the case of *salam*.
- It is agreed among Shariah scholars that the *ḥadīth bay' al-kāli' bi al-kāli'* is weak and, therefore, could not be the basis for a genuine argument.
- Even the claim that that an *ijmā'* (consensus of Muslim scholars in specific issue) had materialized on the issue is also disputed.
- It is most probable that Muslim scholars also relied on the traditionally conceived concept of *salam* as practiced at that time where the price shall be paid in advance. However, this traditionally conceived concept of *salam* by which the price of *salam* must be paid in advance is also contested. For instance, Ibn Hajar in his definition of *salam* stated that "It is the sale of something prescribed in the *dhimmah*.". He added that the phrase that "on condition that the price is paid

⁴³ Ibn 'Abd al-Bar, *al-Kāfi*, vol. 2, p. 4.

at the spot” is questionable because it is not an integral part of the nature of *salam* (*laisa dākhilan fi ḥaḳīqatihi*).⁴⁴

- The centrality of the issue of *riba* and *gharar* in this specific issue is clear in the discussion of Muslim scholars. The whole concept of the prohibition of the sale of debt for debt of which the deferment of both countervalues is one aspect is prohibited mainly on the grounds of the possible existence of either *riba* or *gharar*.⁴⁵
- On the basis of similar grounds, the Malikis have limited the permissibility of delaying the price of *salam* for a period of three days to commodities only. This concession is not applicable to currency exchange or *ṣarf*. For the Maliki, in the case of currency exchange or *ṣarf*, even a delay of going inside a house to bring the exchanged currency is not allowed because this will lead to *riba* prohibited in an explicit authentic *ḥadīth* stating that it should be “hand to hand.” This is the difference between the permissibility of delay for three days in *salam* and the nonpermissibility of such a delay in currency exchange. It is based on the existence and nonexistence of *riba*. It is also argued that the deferment of the subject matter in *salam* constitutes by itself a *gharar* in contrast to the standard sale contract where both countervalues shall be delivered at the formation of the contract. However, *salam* is accepted by way of exception in compliance to the authentic *ḥadīth* of the Prophet. Therefore, allowing a deferment of the price besides the deferment of the subject matter would mean additional *gharar*, which will render the contract void. Therefore, a delay of three days involves only a limited degree of *gharar* and therefore should be allowed. However, as explained, the assumption that *salam* is accepted by way of exception and therefore, it involves *gharar*, is rejected by some early *Fuqahā* (Shariah scholars) as well as modern scholars such Ibn Taymiyyah ibn Qayyim, al-Izz Ibn Abdal-Salam al-Darir, Nazih Hammad, Ajil Jasim, Ahmad Ali Abdullah and others.

⁴⁴ See Ibn Hajar al-Asqalānī. *Fath al-Bārī. bi Sharḥ Saḥīḥ al-Bukhāri*, Maktab al-Kulliyāt al-Azhāriyyah, vol. 9, p. 305. Dasūqī, Mohammad Ibn Aḥmad Ibn ‘Arafah (n.d.) *Hāshiyat al-Dasūqī ‘alā al-Sharḥ al-Kabīr*, vol. 3, p. 197. Ibn Rushd., Mohammad Ibn Aḥmad. *Bidāyat al-Mujtahid wa Nihāyat al-Muqtaṣid*, vol. 2, p. 204. Nihāyat al-Muhtāj, vol. 4, p. 187. al-Fatāwāal-Hindiyyah, vol. 3, p. 187.

⁴⁵ See Ibn Rushd., Mohammad Ibn Aḥmad. *Bidāyat al-Mujtahid wa Nihāyat al-Muqtaṣid*, vol. 2, p. 202; Ibn Qudāmah, Muwaffāq al-Dīn al-Mughnī. vol. 4, p. 328; Ṣiddīq al-Ḍarīr. 1996. “al-Salam wa Tatbiqatuhu al-Mu‘asirah”, *Majallat Majma‘ al-Fiqh al-Islāmī*, ninth session.9 (1) vol. 1, pp. 392; Mohammad al-Mukhtār al-Salāmī. 2000. “Ta’jil al-Badalayn fi al-‘Uqūd” *Nadwat al-Barakah*, no. 19, 2000, pp. 2–5.

Thus, a standard *salam* contract does not involve *gharar* despite the deferment of the subject matter because it is allowed by the Shariah as a standard rule, not an exception, and therefore there is no *gharar*.⁴⁶ In addition, as it is well explained by al-Darir, Muslim scholars agree that “even if there is a level of *gharar* in a specific contract and there is a real need for this contract this *gharar* would be tolerated and it will not invalidate the contract.”⁴⁷

- The possible justification to this limitation of three days by the Malikis, in the case of *salam* in commodity and not in *ṣarf*, is primarily the application of the maxim *ma qārab al-shai’ yu’tā hukmahu*, which means that whenever a case is very close to another they could be given the same rule. First of all, the Malikis consider the sale of debt for debt where both countervalues are deferred as the weaker form of the sale of debt for debt for the simple reason that there is no possibility of *riba* in this case. Second, *gharar* is less in this case than it is in other cases of sale of debt. Another possibility is the prevailing custom. Thus, Ibn Shas, a Maliki scholar said “It is not permissible to include *khiyār al-sharṭ* in currency exchange. However, it is permissible in *salam* for a delay in payment of two or three days because he (the buyer) may need to consult others for a period during which the subject matter will not be affected by any change. Otherwise, the transaction will be a *kind of bay’ al-kālī’ bi al-kālī’*.”⁴⁸ Therefore, it is clear that “The condition that the price of *salam* should be paid at the formation of the contract is stipulated by early scholars in line with their economic conditions” as rightly observed by Mukhtar al-Salami.⁴⁹
- On the other hand, the Maliki’s option to delay the price of *salam* for three days seems to be a subjective limitation. Why three days and not one day or even twenty or thirty days? Does this differ from one *salam* contract to another *salam* contract? Is this different from one

⁴⁶ See Ibn Qayyim, *‘Ilam al-Muwaqq’in an Rab al-‘Alamin*, vol. 1 p. 350; Ibn Hajar al-Asqalānī. *Fath al-Bārī. bi Sharḥ Saḥīḥ al-Bukhārī*, Maktab al-Kulliyāt al-Azhāriyyah, vol. 9, p. 305; ‘Izz Al-Dīn Ibn ‘Abd al-Salām. 1968. *Qawā’id al-Aḥkām fi Maṣāliḥ al-Anām*. vol. 2, pp. 111–112; Nazih Ḥammād. 1996. “al-Salam wa Taṭbiqātuḥu al-Mu’āṣirah”, *Majallat Majma’ al-Fiqh al-Islāmī*, pp. 553–555; Majma’ al-Fiqh al-Islāmī, *Majallat Majma’ al-Fiqh al-Islāmī*, (discussions about *salam*), ninth session, 1996, no. 9, vol. 1, p. 643; Şiddiq al-Ḍarīr (1995), *Al-Gharar wa Atharūḥu fi al-‘Uqūd*, p. 461.

⁴⁷ See *Majallat Majma’ al-Fiqh al-Islāmī*, no. 9, vol. 2, p. 325 & pp. 333–334; Ibn Qudāmah, *al-Mughnī*, vol. 4, p. 326; Ibn Abidin, *Ḥashiyat Ibn Abidin*, vol. 4, p. 284.

⁴⁸ See Ibn Shas, *al-Jawahir al-Thaminah*, vol. 2, p. 461.

⁴⁹ See *Majallat Majma’ al-Fiqh al-Islāmī*, 1996, no. 9, vol. 234.

subject matter of *salam* of contact to another and from one custom to another? The application of this concept by the Maliki school reflects its subjective nature. Thus, even within the Maliki school the ruling may differ if the delay of three days or more is agreed upon by the parties at the formation of the contact or not, and whether the price of *salam* is paid in kind or not.⁵⁰ As al-Ashgar rightly put it in his argument against the Maliki opinion, “If delay for two or three days is permissible it should be permissible for more than that if the economic conditions changed and such a delay will lead to instability and dispute.”⁵¹ Al-Ashgar seems to be right in concluding that if delay for two or three days is permissible, it should be permissible for more than three days if the economic conditions changed. However, his argument that such a delay may lead to dispute is questionable. The practice of the modern forward contract is obvious and shows that there is no instability or dispute in such cases.

- Thus, for the *Fiqh* Academy to follow the Maliki opinion is enough by itself to show that delay of both countervalues in *salam* does not invalidate the contract regardless whether this delay is for three days or more or less if the economic conditions have changed. Yet, as we have explained, the limitation to three days is subjective. Therefore, if it is permissible to delay the price in *salam* for three days it will be permissible to delay it even for more than three days. In contrast, if the delay by itself invalidates the contract, and the length of the delay, even of one day or one hour will invalidate the contract as is the case with currency exchange or *ṣarf*. Moreover, if a delay for three days is permissible in *salam*, which is allowed not as an exception but as a principle, it will be permissible to delay longer than that with regard to the forward contract by way of analogy based on the argument followed in the present study that *salam* is in line with *qiyās* and not against it, and, therefore, it could be the basis for *qiyās*.

Based on the above argument and the fact that *salam* is in line with *qiyās* and not against it, we could say that the modern forward contract is a valid contract by way of analogy to *salam*.

⁵⁰ See al-Hattab, *Mawahib al-Jalil Sharh Mukhtasar Khalil*, Maktabat al-Najat, vol. 4, pp. 514–517; *al-Khirshi ala Mukhtasar Khalil*, Dar Sadir Beirut, vol. 5, pp. 202–204.

⁵¹ al-Ashqar, “Aqd al-Salam” in *Buhūth Fiqhiyyah fi Qadāyā Iqtisādiyyah Mu’asirah*, Dār al-Nafā’is, 1998, vol. 1, p. 193.

Istiṣnāʿ and the Forward Contract

Besides *salam*, the conventional forward contract has also some similarities with the contract of *istiṣnāʿ*, which is a contract for selling a manufacturable thing with an undertaking by the seller to present it manufactured from his own material, with specified descriptions and at a determined price.⁵² As in the case of *salam*, for the contract of *istiṣnāʿ* to be legal, several conditions should be fulfilled. Those conditions are:

1. The object of the contract must be precisely determined both in its essence and quality.
2. The time of delivery must be specified (short or long) to avoid confusion of date of delivery, which may otherwise lead to conflict between the parties.
3. The manufacturer should supply the material. If the material is supplied by the buyer, the contract is *ijāra* and not *istiṣnāʿ*.
4. The place of delivery should be specified if the commodity needs loading or transportation expenses. In addition, it is important to note that unlike *salam* it is not a condition in *istiṣnāʿ* to advance the payment, though it is permissible to do so. Otherwise it could be deferred or made in instalments. Moreover, it is not a condition that the seller be an expert in manufacturing.⁵³

Thus, *istiṣnāʿ* is more in line with the conventional forward contract where the price is not paid in advance as well. However, according to the majority of Muslim jurists, *istiṣnāʿ* cannot be applied to commodities that are normally available in the market. It is basically a manufacture or production contract unlike *salam*, which is basically a trading contract. Thus, a seller agreeing to provide a product in the future under *istiṣnāʿ* will have to be a producer or have to establish a parallel contract with a producer.⁵⁴ It is clear from the contractual specifications of *istiṣnāʿ*

⁵² Muṣṭaphā al-Zarqā, 'Aqd al-Istiṣnāʿ wa madā Ahammiyatuhu fi al-Istithmārāt al-Mu'āṣirah, (Lecturer series of renowned scholars no. 12.), Jeddah Islamic Development Bank, 1995, p. 12.

⁵³ See Islamic Fiqh Academy's resolution no. 66 /3/7 on *istiṣnāʿ*; Muṣṭaphā al-Zarqā 'Aqd al- *istiṣnāʿ* wa madā ahammiyatuhu fi al-Istithmārāt al-Islāmiyah al-Mu'āṣirah, Islamic Development Bank, Jeddah, 1995, p. 11; Muhammad al-Bashir Muhammad al-Amine, *Istiṣnāʿ in Islamic Banking and Finance: The Law and Practice*, A.S. Nordin, Kuala-Lumpur, Malaysia, 2001, pp. 48-53.

⁵⁴ Ibid.

that it is almost the same as the modern forward contract. It should be noted that the deferment of price in *istiṣnā'*, according to the classical scholars, is allowed on the basis of *istiḥsān* and need rather than norms. Therefore, one may argue that the need for the modern forward contract is similar to that of *istiṣnā'* if not *moreso*. Thus, it should be allowed on the same grounds. The difference between *istiṣnā'* as a production contract and the modern forward contract as a trading contract should not be used as an excuse to reject the forward contract.

It is noteworthy that although *salam* and *istiṣnā'* are not typical forward contracts, they do fulfill some of its benefits. The following example will illustrate. Suppose the defense department of a country needs for its army one million uniforms which would require about six million meters of cotton cloth. It is not possible for any supplier to provide these uniforms from its ready stock. The supplier approaches the largest textile manufacturer. Looking at his present commitment, the manufacturer would require about twelve months to manufacture and deliver six million meters of cloth. The manufacturer will not be able to deliver the cloth on time if for some reason the raw cotton goes into short supply after six months, when he would need it. Therefore, to be on the safe side he enters into a firm commitment with wholesale dealers of raw cotton to start supplying after five months and continue its supply over the next six months. The wholesale dealers enter into an agreement with farmers to supply raw cotton at the required future date. The price to the farmers is settled in advance. Looking at their costs and the sale price, the farmers can decide on their acreage for cotton and make efforts to control their expenses.

In this chain, a number of agreements take place. The farmers agree to supply raw cotton to the wholesalers, who agree to supply it to the textile manufacturer. The manufacturer agrees to supply the cloth to the contractor supplier who arranges to stitch uniforms and supply them to the defense department. At each stage the price is settled in advance while the object of sale is not in existence.

The contract between the supplier of the uniforms and the defense department and between the supplier of the uniforms and the textile manufacturer is covered by the rules of *bay' al-istiṣnā'*. Under *bay' al-istiṣnā'* the two parties can agree on the sale of a nonexistent product as it is elaborated. A certain percentage of the sale price as an advance is also permissible. The contracts between the textile manufacturer and the wholesaler and between the wholesaler and the farmer are covered

by the law of *bay' al-salam*.⁵⁵ Thus, in this transaction *istiṣnā'* and *salam* achieved some of the benefits of the conventional forward contract. However, this may not be always the case and there is a need for the adoption of the forward contract in Islamic finance.

Ibtidā' Al-Dayn Bi Al-Dayn and the Forward Contract

The sale of debt for debt, called by the Mālikīs *ibtidā' al-dayn bi al-dayn* (deferment of both countervalues), is at the core of forward trading. Therefore, we shall try to discuss it briefly here while deferring the detailed discussion on debt trading to our analysis of *bay' al-dayn bi al-dayn* in general. The different schools of law have prohibited this form of sale of debt, for various reasons. For some the sale involves *ribā* while for others it is *gharar*. The Mālikīs consider this form of *bay' al-dayn bi al-dayn* as one of the lesser evils.⁵⁶

Rafīq al-Maṣrī, for instance, argued that no extra *gharar* is involved in deferring both countervalues compared to the deferment of one of them only. In other words, if one of the countervalues has been delivered while the other is deferred for a future date or both of them are deferred, the level of risk is the same and there is no possibility of extra *gharar*. Let us assume a case where a buyer receives a commodity but defers the payment of the price; there is a possibility that during this period the price of the commodity may fluctuate. Therefore, one of the parties will bear the impact of this fluctuation. It could be the seller if the spot price goes up or the buyer if the opposite happens. This is what always occurs in the case of *salam*. The risk will be the same even if both countervalues are deferred. Of course, in the case of deferment of just one countervalue, one of the parties to the contract will benefit from his receipt either of the commodity in the deferred sale or the price in the case of *salam*. However, the *gharar* remains the same, even if both countervalues have been deferred. Both parties will share the instant

⁵⁵ See Muhammad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," *American Journal of Islamic Social Science*, vol. 5, issue. 1, 1988, pp. 96–97.

⁵⁶ See for instance, al-Jaṣṣaṣ, *Aḥkām al-Qur'ān*, Dār al-Fikr, Beirut, vol. 1, p. 483; al-Shāfiī, *al-Umm*, al-Sha'ab, Cairo, vol. 3, p. 87; al-Nawawī, *al-Majmū'*, vol. 9, p. 435. Ibn Taymiyyah, *al-Qiyās*, Dār al-Āfāq al-Jadīdah, Beirut, 1982, p. 16.

risk, as it is in the case of *mushārah*. Therefore, in a case where the price remains stable both parties will not be affected. However, if the prices go down, the buyer will be affected as opposed to the seller. Thus, there is no difference in the level of risk in both situations, and there are no grounds for the claim made by some scholars that the risk or *gharar* would be greater if both countervalues were deferred.

On the other hand, it should be noted that there is a need for such a sale (where both countervalues are deferred, that is, the forward contract), similar to the need for *salam*. It is possible that someone may be in need of a commodity in the future and he may not possess the money for it at the time of the contract or he may want to pay it by installments. Therefore, the forward contract will solve such a problem. At the same time, the seller may not be in need of the payment as the case of *istiṣnāʿ* and *tawrīd* contracts (forward contracts).

Rafiq al-Maṣrī went on to argue that only the Ḥanafīs allowed the deferment of both countervalues in *istiṣnāʿ* based on *istiḥsān*, making it a separate contract from *salam*. Therefore, it will be useful if the deferment of both countervalues is allowed in the sale using a *tawrīd* or (forward contract) on the same ground.⁵⁷ He concluded that the sale where both countervalues are deferred may sometimes involve a benefit for the contracting parties and since the *ḥadīth* concerning the prohibition of *bayʿ al-kāli bi al-kāli* is not authentic, then it is irrelevant to think that this contract and other similar contracts are against *sharīʿah* rules. Indeed, we acknowledge that some cases involving the deferment of both countervalues may involve harm or a suspected interest. However, this does not apply to all cases, such as, for example, the contract of *tawrīd* (forward contract). It is possible to accommodate this contract on the basis of the general principles without resorting to *istiḥsān* (departure from a ruling in a particular situation in favour of another ruling, which brings about ease).⁵⁸ Furthermore, the objective of the forward contracts or *ʿuqūd al-tawrīd* is to satisfy the need of some public institutions, factories, and construction companies, which are in need of certain materials on a specific date and may not be in need of the money at the time of the contract. This is in contrast to the

⁵⁷ For more details, see Rafiq al-Maṣrī, *al-Jāmiʿ fiʾUṣūl al-Ribā*, Dār al-Qalam, Damascus, 1991, pp. 339–344.

⁵⁸ *Ibid.*, pp. 346–347.

objective of paying the cost at the time of the contract in *salam*, which is to finance the seller.

Refuting the claim of involvement of *gharar* that might lead to dispute due to the deferment of both countervalues, Mukhtār al-Salāmī observed that the basic possibility of dispute is present in all forms of transactions, which did not render these transactions invalid. However, if it is argued that the possibility of dispute is higher in the case of the deferment of both countervalues, then this is not true. The contracting parties will specify clearly the price and the subject matter in a written agreement. Therefore, the possibility of dispute is minimal and the history of transactions in the future contracts market testifies to that.⁵⁹

It should be noted in this connection that the very conservative view taken by the majority of classical Muslim scholars is based on their misconception that a *salam* contract is admitted or legalized against the norms or *qiyās*.⁶⁰

Bay' Al-Şifah and the Forward Contract

Bay' al-şifah is the sale of something, well described, that is not present at the time of contract but will be delivered in future.⁶¹ Although the sale by description or *bay' al-şifah* is accepted by the Ḥanafīs⁶² and Ḥanbalīs,⁶³ the approach taken by the Mālīkīs⁶⁴ is more in line with our analogy between *bay' al-şifah* and the forward contract. The Ḥanafīs validate the sale by description or *bay' al-şifah* and they guarantee the buyer the option of inspection (*khiyār al-ru'yah*) whether the subject matter of the contract is presented according to the agreed upon conditions or not.⁶⁵ On the other hand, the Mālīkīs and Ḥanbalīs guarantee

⁵⁹ Mukhtār al-Salāmī, "Ta'jil al-Badalain fi al-'Uqūd," paper presented in Nadwat al-Barakah al-Tāsia'h 'Asharah lil iqtisād al-Islāmī, Makkah al-Mukarramah, 2–3 December 2000, p. 3.

⁶⁰ Al-Kāsānī, *Badā'ii al-Sanā'ii*, al-Matb'ah al-Jamāliyyah, Egypt, 1967, vol. 5, p. 201; Ibn Rushd, *Bidāyat al-Mujtahid wa Nihāyat al-Muqtaşid*, Dār al-Kutub al-Ḥadīthah, Egypt, vol. 2, p. 228; and al-Buhūti, *Sharḥ Muntahā al-Irādāt*, Egypt, vol. 2, pp. 218–221.

⁶¹ See Ibn Rusd, al-Muqaddimāt al-Mumahhadāt, Beirut, Dār al-Gharb al-Islāmī, 1988, vol. 2, p. 76.

⁶² See Ibn 'Ābidīn, *Rad al-Muhtār 'alā al-Dur al-Mukhtār*, Dar al-Kutub al-'Ilmiyyah, Beirut, vol. 4, p. 21.

⁶³ al-Buhūti, *Sharḥ Muntahā al-Irādāt*, Egypt, vol. 2, pp. 218–221.

⁶⁴ Al-Dirdīr, *al-Sharḥ al-Kabīr 'alā Khalīl*, Beirut, Dār al-Fikr, Beirut, vol. 3, p. 27.

⁶⁵ *Ibid.*

the buyer the right to *khiyār al-ru'yah* only when the commodity is presented without fulfilling the conditions required.⁶⁶ However, the Mālikīs and Ḥanbalīs differ in the mode of payment. It is a principle in the Mālikī school⁶⁷ that the price must not be paid at the time of the conclusion of the contract in contrast to the principle in the Ḥanbalī school.⁶⁸ Moreover, according to the Mālikīs, *bay' al-ṣifah* is permissible in everything, while the Ḥanbalī school restricts it to what is permissible in *salam* only. The above concept of *bay' al-ṣifah* in the Mālikī school is in line with our analogy.

On the possibility of accommodating the conventional forward contract as a kind of *bay' al-ṣifah*, 'Abd al-Wahhāb Abū Sulaimān maintained that first, *bay' al-ṣifah* and then, the forward contract, are based on a detailed description of the subject matter, relying on previous observation. Second, in both contracts the subject matter is absent and the parties have a real intention to fulfill the contract and want it to be executed according to the time and place specified. Third, both contracts fulfill the characteristics of *bay' al-ṣifāt* (sale by description) and not *bay' al-'a'yān* (the sale of objects in rem). Lastly, in both contracts both contrevalues are deferred although the price could be paid by installments as well.⁶⁹

Given the close similarities between the two contracts and the fact that the conventional forward contract is immune from *ribā* and *gharar*, which are the most commonly advanced arguments to invalidate it, we could say the forward contract is a valid contract in Islamic law. The forward contract is immune from *gharar* in the sense that the possibility of the seller not being able to make delivery (due to difficulties in getting the subject matter of the contract) is very remote and could not be compared to cases of "birds in the sky" or "fish in the deep sea," which represent the standard concept of *gharar*. Similarly, there is no risk regarding the subject matter of the contract since it is well defined and not similar to cases such as "I am selling to you what is in my hand" or "what is in my box" without showing it.⁷⁰

⁶⁶ al-Zurqānī, *Sharḥ al-Zurqānī 'alā Muqtaṣar Khalīl*, Beirut, Dār al-Fikr, Beirut, 1978, vol. 5, p. 38; Ibn Qudāmah, *al-Mughnī*, Dār al-Fikr, Beirut, vol. 4, p. 56.

⁶⁷ Al-Dirdir, *al-Sharḥ al-Kabīr 'alā Khalīl*, Beirut, Dār al-Fikr, Beirut, vol. 3, p. 27.

⁶⁸ al-Buhūtī, *Kashshāf al-Qinā'*, vol. 3, p. 164.

⁶⁹ See 'Abd al-Wahhāb Abū Sulaimān, "Aqd al-Tawrīd Dirāsah Fiqhiyyah Taḥlīliyyah," paper presented to the twelfth session of the Islamic Fiqh Academy, Rabat, Morocco, pp. 2–3.

⁷⁰ *Ibid.*, pp. 44–47.

Aḥmad ‘Ali ‘Abd Allāh has also argued in favor of the permissibility of the forward contract by analogy to *bay‘ al-ṣifah*. He maintained that *salam* is accepted according to the norms of *shariah* and it is not against *qiyas* as it is claimed by many scholars. Therefore, we can make an analogy by considering the *salam* a kind of *bay‘ al-ṣifah* in order to accommodate the conventional forward contract. He also refuted the claim that it is part of the prohibited sale of debt for debt or the sale of what is not with you.⁷¹

*Nonexistence of the Subject Matter and
the Forward Contract*

The importance of studying the existence of the subject matter of a contract during the conclusion of a forward contract lies, first of all, in the fact that the forward contract is basically a future trading contract where the matter is nonexistent at the time of the contract. Second, due to their interpretation of the *ḥadīth*, “Do not sell what is not with you,”⁷² many scholars have rejected the forward contract because it is not similar to *salam*. They argued that it must fulfill all conditions of *salam* in order to be legal. However, for Ibn Qayyim there is nothing in the *sharī‘ah* which is against *qiyās*. Moreover, everything which is supposed to be against *qiyās* is in fact inseparable from one of two things: either the *qiyās* or analogy itself is not valid or there is no textual evidence to prove that the rule under discussion is from the *sharī‘ah*, because the genuine *qiyās* represents the justice for which Allah (s.w.t.) has sent His Messenger. Therefore, there is nothing in the *sharī‘ah* which contradicts the genuine *qiyās*.⁷³ Even the contract of *salam*, which has been accepted by some scholars only due to the specific *ḥadīth* concerning it, is considered against *qiyās*, although for Ibn Qayyim it is in accordance with *qiyās*.⁷⁴ Ibn Qayyim refutes the claim of certain scholars that the sale of nonexistent things is prohibited in Islamic law. He argues that there is no evidence from the Book of Allah, the Sunnah of His Prophet, or the saying of any of the Companions that the sale of a nonexistent item is

⁷¹ Aḥmad ‘Ali ‘Abd Allāh, “al-Bay‘ ‘alā al-Ṣifah,” pp. 3–15.

⁷² Abū Da‘ūd, *Sunan*, *ḥadīth* No. 2187.

⁷³ Ibn al-Qayyim, *I‘lām al-Muwaqqi‘in ‘an Rabbi al-‘Ālamīn*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Lebanon, 1991, vol. 1, pp. 383–4.

⁷⁴ *Ibid.*, vol. 1, p. 399.

illegal, but rather what is reported in the Sunnah is the prohibition of some existing items and some nonexistent ones as well. Therefore, the *ratio decidendi* of this prohibition is not the existence or the nonexistence of the subject matter. What is at issue in the Sunnah is the prohibition of any kind of sale involving risk (*gharar*), where it is impossible to deliver the item, whether it exists or not.

Furthermore, the Lawgiver has permitted the sale of some nonexistent items in certain cases, such as the sale of fruits, which have appeared on the trees but have not yet ripened and are therefore not of immediate use at the time of the contract.⁷⁵

After elaboration of the basic principles related to this *ḥadīth*, we now move on to the issues concerning interpretations of the *ḥadīth*. They are as follows:

1. “Do not sell what is not with you” means not to sell what one does not own (*la tabi‘ma laisa ‘indaka*) at the time of sale. One of the basic requirements of sale, as al-Kāsānī stated, is that the seller owns the object of sale when selling it, failing which the sale is not concluded, even if the seller acquires ownership later. The only exception is the *salam* sale, where ownership is not a prerequisite. According to this interpretation, al-San‘ānī stated that this phrase implies that it is not permitted to sell something before owning it. Ibn al-Humām and Ibn Qudāmah similarly concluded that a sale involving something that the seller does not own is not permitted even if he/she buys and delivers it later.⁷⁶
2. Some other jurists and *ḥadīth* scholars hold that this *ḥadīth* applies only to the sale of specified objects (*al-‘a‘yān*) and not to fungible goods, as these can be substituted or replaced with ease. Al-Baghawī⁷⁷ and al-Khattābi,⁷⁸ in contrast, are among the scholars who stated that this prohibition is confined to the sale of objects in rem (*buyū‘ al-‘a‘yān*) and does not apply to the sale of goods by description (*buyū‘ al-ṣifāt*). Hence, when *salam* is concluded for fungible goods that are readily available in the locality, it is valid even if the seller

⁷⁵ Ibn Qayyim, *I‘lām al-Muwaqqi‘in*, vol. 1, p. 219.

⁷⁶ Muhammad Ibn Ismā‘il al-San‘ānī, *Subul al-Salām Sharḥ Bulūgh al-Marām*, al-Maktabah al-Tijāriyyah, Cairo, n.d., vol. 3, p. 17.

⁷⁷ al-Baghawī, Abū Muhammad al-Ḥusayn, *Sharḥ al-Sunnah*, al-Maktab al-Islāmī, Damsqus, n.d., vol. 8, pp. 140–141.

⁷⁸ Al-Khattābi, *Ma‘ālim al-Sunan*, Cairo, Matb‘at al-Sunnah, n.d., vol. 5, p. 143.

does not own the object at the time of contract. Al-Khattābī has said that this *ḥadīth* refers to the sale of specific objects for the Prophet permitted deferred sales of various kinds, in which the seller did not have the object of sale at the time of contract. In essence, this prohibition seeks to prevent *gharar* in sales (e.g., a runaway camel, uncertainty over delivery, and sale of someone's property without his or her permission).

3. A third position is that a sale of "what is not with you" means the sale of what is not present and what the seller cannot deliver. This is the view of Ibn Taymiyah, who stated that the emphasis is on the seller's inability to deliver, which entails risk-taking and uncertainty (*mukhāṭarah wa gharar*). If the *ḥadīth* were taken at face value, it would proscribe *salam* and a variety of other sales. However, this is obviously not intended. The Prophet forbade Ḥakim Ibn Ḥizām to sell the particular objects either because he might not own them or because he might not be able to deliver them. The latter reason is more likely to be the basis for the prohibition, otherwise the cause or *'illah* is available even in *salam*. Some Mālikis held similar views. It is quite possible that the seller owns the object but is unable to deliver it, or that the seller possesses the object but does not own it. In either case, the sale would fall within the purview of this *ḥadīth*. Therefore, the *ḥadīth* underlines neither ownership nor possession, but rather the seller's effective control and ability to deliver. Therefore, the only effective cause of the prohibition (*'illah*) is *gharar* on account of one's inability to deliver.⁷⁹

Finally, some contemporary legal writers such as 'Ali Abd al-Qādir,⁸⁰ Yusuf Mussā,⁸¹ and Yusuf al-Qaradāwī⁸² have considered the changes of the market in the present circumstances compared to the time of the Prophet. During the Prophet's time the market was so small that it did not give the assurance of regular supplies at any given time. In contrast, the modern markets are regular and extensive, which means that the seller can find the goods at almost any time and make delivery

⁷⁹ al-Baghawī, Abū Muhammad al-Ḥusayn, *Sharḥ al-Sunnah*, vol. 8, pp. 140–141.

⁸⁰ 'Ali Abd al-Qādir, "Ta'qīb 'alā Rai' al-Tashrī' al-Islāmī fi Masā'il al-Burṣah," p. 439.

⁸¹ Muhammad Yousuf Musa, *al-Buyū' wa al-'Amaliyyāt al-Māliyyah al-Mu'āshirah*, Cairo, Dār al-Kitāb al-'Arabī, 1954, p. 193.

⁸² al-Qaradāwī Youssuf, *Bay' al-Murābahah li al-'Āmir bi al-Shirā' Kamā Tujrīh al-Maṣārif al-Islāmiyyah Dirāsah fi Daw' al-Nuṣūṣ wa al-Qawā'id al-Shar'iyyah*, Cairo, Maktabat Wahbah, 1987, p. 19.

as may be required.⁸³ Therefore, the possibility of *gharar* or a dispute is not present here.

However, despite the numerous Islamic principles by which the conventional forward contract could be accommodated and despite the weakness of the different arguments advanced against its legality, some scholars⁸⁴ still insist that if the forward contract is considered a binding contract, then it is an invalid contract. Therefore, according to these scholars, to meet the real need for such a transaction, it must be considered as a mutual promise between the two parties but not a contract. Thus, both parties must fulfill their promise but if one of them cannot do so for genuine reasons, he will not be obliged to do so. But if he fails to meet his obligations without genuine reasons, he shall be obliged by the court to pay damages to the affected party.

However, it should be noted that despite the fact that these scholars attempted to draw a distinction between a contract and a promise that is binding upon both parties, it seems difficult to maintain these differences in practice.

Thus, we argue that the conventional forward contract has great benefits and it could be accommodated in Islamic law whether under the general theory of contract and conditions or by analogy to *salam*, *'istiṣnā'*, or *bay' al-ṣifah*, since it does not involve *ribā* or *gharar*. Moreover, it is not included in the prohibited forms of sale of debt nor does it oppose the principle "do not sell what is not with you."

Before concluding our discussion of the forward contract in commodities, it is worth noting that although spot trading is basically a contract for the physical delivery, sometimes the contract may involve some elements of forwarding. Thus, for instance, in crude oil a spot trading is a contract for the physical delivery of crude oil as soon as possible. Because of the volume of the commodity involved in oil trading and the logistic difficulties of transporting it from place to place, it is fair to say that in respect to oil nearly all "spot" trading involves an element of passage of time or forwarding. Refineries often book oil into their refining runs several weeks in advance and although these are considered "spot" orders, the distinction between spot, forward,

⁸³ For further details, see Kamālī, "Islamic Commercial Law, An Analysis of Futures," *The American Journal of Islamic Social Sciences*, vol. 13, Summer 1996, no. 2, pp. 205–7.

⁸⁴ See Taqī al-Usmānī, "Uqūd al-Tawrīd wa al-Munāqaṣāt," paper presented at the twelfth session of the Islamic Fiqh Academy, pp. 3–11.

and other derivatives trading is not clear in all business.⁸⁵ Furthermore, if the permissibility of the forward contract in commodities is established as it has been elaborated, how about the exchange of gold on a deferred basis?

⁸⁵ Edward J. Swan, McKenna & Co., "Derivatives and the Control of Oil," Edward J. Swan, (ed.) *Derivatives Instrument Law*, Cavendish Publishing Limited, p. 52.

CHAPTER THREE

IS IT PERMISSIBLE TO EXCHANGE GOLD WITH PAPER MONEY ON FORWARD BASIS?

The discussion of the forward market in commodities will not be complete unless the issue of trading gold on a forward basis is explored. First of all, it should be noted that the different *aḥādīth* on the issue have explicitly mentioned that gold for gold, silver for silver, and gold for silver should be traded hand to hand or on a spot basis. However, this rule is based, according to the majority of Muslim jurists, on a rationale or *'illah* applicable to silver and gold. Yet the different schools of Islamic law have issued several interpretations to determine this *'illah*. The question arises as to whether these different *'ilal* or causes postulated by the classical jurists are still relevant to the prohibition of gold and silver trading on a forward or *nasī'ah* basis at present. However, first the study will give a brief history of the world monetary system due to the central position of gold in it on one hand, and due to the fact that if gold is still money it will not be permissible to trade on a forward basis while it would be possible to do so if gold lost this characteristic.

Historical Sketch of the World Monetary System

There are two basic types of economic trading system: barter economies and monetary economies. Each system, in turn, can take different forms. Barter is the direct exchange of goods and services for other goods and services. There must be a double coincidence of wants. However, a pure barter economy has several shortcomings, such as absence of a method of storing generalized purchasing power, absence of a common unit of measure and value, and the absence of a designated unit to use in writing contracts requiring futures payment.¹

¹ See Roger LeRoy Miller and David D. VanHoose, AC, *Modern Money and Banking*, McGraw-Hill, USA., Third International Edition, 1993, pp. 10–12.

On the other hand, money has existed in diverse forms. Most types of money that were used are commodities monies. They are physical commodities monies. Early commodities monies, such as wool, boats, sheep, and corn had equivalent monetary values and nonmonetary values. More advanced societies that were able to mine and process scarce metals like gold and silver found that these metals possessed in abundance the key properties of satisfactory money. Gold and silver are recognizable and are durable metals. While heavy, they nonetheless are portable. It is possible to measure their purities as metals, so that individuals can standardize them by both weight and degree of purity. Heating and chemical and physical processes can make gold and silver completely divisible. For this reason, gold and silver have been predominant types of commodity monies.² The following is a list³ of some of the different types of money that have existed throughout history.

Iron	Red woodpecker scalps	Leather
Copper	Feathers	Gold
Brass	Glass	Silver
Wine	Polished beads (wampum)	Knives
Corn	Rum	Pots
Salt	Molasses	Boats
Horses	Tobacco	Pitch
Sheep	Agricultural implements	Rice
Goats	Round stones with centers	Cows
Tortoise shells	removed	Slaves
Porpoise teeth	Crystal salt bars	Paper
Whale teeth	Snail shells	Cigarettes
Boar tusk	Playing cards	

On the other hand, the monetary system that prevailed during the Prophet (PBUH) days was essentially a bimetallic standard with gold and silver coins circulating simultaneously. The ratio that prevailed between the two coins at that time was 1:10. Such stability did not, however, persist. The two metals faced different supply and demand conditions which tended to destabilize their relative prices. Thus, during the Umayyad period it reached 1:12, while in the Abbasid period after

² Ibid.

³ Ibid., p. 12.

that, it reached 1:15. The decline of silver continued until it reached 1:35 and 1:50 at certain times. When the United States adopted bimetallism in 1792, the gold/silver price ratio was 1:15. However, the fluctuating price of both metals led the United States to demonetize silver in 1873. The experience of several other countries suggests that bimetallism was a fragile standard. This was the cause of its universal demise.⁴

Silver continued to loose ground and the gold standard become prevalent around the world and emerged as the true international standard by 1880. Monometallism hence took its place. Under this standard, the value of a country's currency was legally defined as fixed weight of gold and the monetary authority is under an obligation to convert the domestic currency demand into gold at the legally prescribed rate. Historically, there have been three variants of the gold standard: the gold coin standard, when gold coins were in active circulation; the gold bullion standard, when gold coins were not in active circulation but the monetary authority undertook to sell gold bullion against the local currency at the official rate; and the gold exchange standard (or the Bretton Woods system) when the monetary authority was required to exchange domestic currency for US dollars which could be converted into gold at a fixed parity. The rules of the gold standard required deficit countries to deflate and the surplus countries to reflate their economies. This seemed unrealistic during the Great Depression when the deficit countries had no alternative but to reflate the economies to reduce unemployment.⁵

The financial needs of the Second World War and post-War reconstruction made the return to the gold standard even more difficult and the Bretton Woods system become universally adopted after the Second World War. US dollars became the cornerstone of this system because at the end of the Second World War the United States had around two-thirds of the world's monetary gold. By the late 1950s, the growth of the world monetary gold stock was insufficient to finance the growth of world output and trade. The dollars supplied by the United States deficit helped provide the needed liquidity. However, the persistent US deficits led to a continuous decline in its gold holdings and undermined its ability to maintain the dollar's convertibility into gold. Ultimately the

⁴ Umer Chapra, "Monetary Management in an Islamic Economy," *Islamic Economics Studies*, Islamic Development Bank, vol. 4, no. 1, 1996, pp. 1-2.

⁵ *Ibid.*, pp. 2-3.

US was forced to demonetize gold in August 1971. Thus, a new era of fully-fledged managed money standard having absolutely no link with gold emerged. The system, which at first was adopted by the force of circumstances, acquired an official character after the ratification of the Second Amendment to the IMF Articles of Agreement April 1978.⁶

Critical Analysis of Several Fatwās on Gold Trading

In order to explore the opportunities available in the international gold market, several Islamic banks have requested clarification about the issue from their respective *sharī'ah* boards. However, there is no definitive answer and some of these *sharī'ah* boards have tried to repeat the prevailing stand on the issue without relating it to the current reality.

Thus, the International Association of Islamic Banks in its working paper presented to the high *sharī'ah* board for a *sharī'ah* ruling on the issue, in its formulation of a request by the Dubai Islamic bank for a *fatwā* on the issue said: Given the fact that Islamic banks are not dealing in the currency market like conventional commercial banks, and since the investment in the gold market provides considerable and fundamental guarantees for good investment, the gold market has become a very attractive one for Islamic banks. In other words, some of these banks found the gold market as a good alternative to the currency market. In addition, although the gold market is also not immune from the market forces of loss and profit, it is much more stable, the liquidity is better, and the risk is less, given the quick response and better analysis. Furthermore, gold and other precious metals have organized markets and trading in gold is through special brokers. The following two are among the different modes of transaction in these markets:

1. Buying gold and keeping it for sale when the prices are better.
2. Exchanging a mutual promise for the purchase or sale with mutual delivery taking place at an agreed upon date in the future. In other words, the parties agree upon the purchase or sale of a specific amount of gold of a specific quality to be delivered at a future date. The mutual promise is executed at maturity.

⁶ Ibid., p. 3.

Therefore, the Dubai Islamic Bank requested the Association to give its *fatwā*⁷ on the issue with all the arguments and supporting evidence. It will be noted, of course, that the issue is of general interest to all Islamic banks.

The response of the *sharī'ah* board was as follows: first of all, the bases for problems relating to the issue of gold trading, whether real or hypothetical, are no longer present nowadays. The medium of exchange and currencies have taken a new form. However, some Muslims still consider these currencies as they were before, namely backed by gold or silver. Thus, if the present currencies of paper money are exchanged with each other, some consider it as an exchange of gold or silver with each other. Therefore, they inquire about the existence of *ribā al-faḍl* (*Riba* pertaining to trade contracts. It refers to exchange of different quantities (but different qualities) of the same commodity. Such exchange in particular commodities defined in the *sharī'ah* is not allowed.) or *ribā al-nasī'ah* (*Riba* pertaining to loan contracts). However, the concept of currency as it is reported in the classical *fiqh* books no longer exists today in international economic thought. The nature of the present currency is that of currencies backed by the law of the country and as part of the total output of the national economy, whether goods or services. If gold or silver is traded in exchange for these currencies it does not represent an exchange of gold or silver with each other. Therefore, gold trading as presented in the question is not an exchange of gold for gold, because the paper money is not gold but part of the national output of goods and services. In such a transaction, there is no possibility of *ribā*, because one of the countervalues is gold while the other is not.

The board went on to say that although the classical scholars had based their analysis on the concept of currency backed by gold and silver, this would not be the mechanism for those who came after them with regard to modern currency. The modern economic system is based on developed economic thought and it is a necessity imposed on our societies. On the other hand, the *sharī'ah*, which is viable for all times and places, would not reject such a mechanism. Therefore, to stick to something that has already been superseded by time contradicts the nature of the *sharī'ah*, which does not recognize stagnation or *ḥaraj*.

⁷ See Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Sharī'iyah fī al-Masā'il al-Iqtisādiyyah*, Kuwait, 1988, pp. 546–553.

The *Shari'ah* Board of the International Association of Islamic Banks continues its argument by pointing out that the classical concept of currency was not a binding *shari'ah* rule but a matter of custom at that time. Therefore, it is not necessary to abide by it. This is based on the saying of the prophet, "Do not sell gold for gold unless equal for equal and with equal measurement." Commenting on the *hadith*, Abū Ḥanīfah and his disciple Muhammad al-Shaybāni said, "What is reported in the text as weighable or *kailiyyan* should remain forever so." However, Abū Yousof, the other disciple of Abū Ḥanīfā, disagreed on the issue. For him what is reported as weighable could be *kailiyyan* and vice versa according to the prevailing custom. And what is reported in the text (*naṣ*) is just what prevailed at that time.⁸

Inspired by this argument, the Board maintained that the classical concept of currency was not a binding *shari'ah* rule but a matter of custom at that time. Therefore, we should not base our analysis on the concept of currencies, which are based on or backed by gold. Finally, it should be noted that, in principle, all transactions are valid unless they contradict a clear *naṣ* or text, which is not available in the case before us.⁹

However, it seems that this opinion is based on shaky legal arguments. First of all, this analysis disregards totally the *'illah* or the *ratio* behind selling gold for gold on a deferred basis. Second, it considers modern currencies as commodities. Such an opinion could be considered a very dangerous move, which would open the doors for *ribā* in Muslim economies. Third, it draws an analogy between the present case, namely gold trading on deferred basis, and the opinion taken by Abū Yousof in the above-mentioned case. However, since it did not discuss the *'illah* or the cause behind the prohibition of this transaction, then such an analogy would be discrepant. Even the *'illah* in gold and silver, as it is understood by the Hanafi school in general, namely the weight, is unacceptable nowadays with the advent of the banknote which is not at all weighable. And if these currencies, which are nowadays the sole medium of exchange and source of value, are not considered *ribawi* (involving *riba*), we would have undermined the very objective of the *shari'ah* in prohibiting the exchange of gold and silver on a deferred

⁸ al-Kasānī, *Badā'i al-Ṣanā'i*, Dār al-Kitāb al-'Arabī, Beirut, 2th edition, 1983, pp. 185–190.

⁹ Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtisādiyyah*, Kuwait, 1988, pp. 546–553.

basis. Unfortunately, some modern Muslim jurists have followed the Ḥanafīs and Imāmi's opinion and concluded that modern paper money is not *ribawi* because it is not weighable.¹⁰ If we use this line of argument, we may conclude that it is permissible to trade gold in exchange of paper money on a deferred basis.

Perhaps one can find an excuse for those who maintained such an opinion before the end of the convertibility of the dollar with gold, but no excuse is viable for those who continue to hold such an opinion even after almost every country around the globe followed the United States and ended the relation between gold and their respective currencies.

The previous *fatwā* has been strongly opposed by the *sharī'ah* adviser of the Kuwaiti Finance house.¹¹ He argued that gold and silver are considered by the Lawgiver as mediums of exchange, whether they are coin, bullion, or in the form of jewelry. Therefore, the rules of *ṣarf* of equal for equal and hand to hand should be observed based on the numerous *ḥadīths* reported in this connection, and which did not make any difference between coin, bullion, and jewelry.¹² To cite an example, it is reported by Abū Saïd to the effect that the Prophet had said, "Do not sell gold for gold unless equivalent in weight, and do not sell a lesser amount for a greater amount or vice versa; and do not sell gold for silver that is not present at the moment of exchange for gold or silver that is present."¹³ In another *ḥadīth* it is said, "Gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, and salt for salt—like for like, equal for equal, and hand to hand; if these commodities differ, then you may sell as you wish provided that the exchange is hand to hand."¹⁴ Commenting on this *ḥadīth*, al-Shawkānī said that the term "gold for gold" includes all kinds of gold, whether coin, bullion, or jewelry of excellent quality or mixed. Al-Nawawī and others reported *ijmā'* about this.¹⁵

Therefore, the *sharī'ah* advisor maintains that it is clear that there is no difference between the different kinds of gold. Concerning the exchange of these different kinds of gold with paper money, we believe the *sharī'ah* adviser added that paper money has the same characteristics as gold

¹⁰ Baqir al-Ṣadr, *al-Bank al-LaRiawi*, p. 173.

¹¹ Bayt al-Ṭamwīl al-Kuwaitī, *al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtiṣādiyyah*, pp. 546–553.

¹² See Abū Dā'ūd, Sunan Abī Dawūd with 'Awn al-Ma'būt, vol. 9, p. 198.

¹³ Mālik Ibn 'Anas, *al-Muwatta'*, vol. 2, p. 632.

¹⁴ Al-Bukhārī, *Ṣaḥīḥ al-Bukhārī*, vol. 4, p. 379.

¹⁵ al-Shawkānī, *Nayl al-Awṭār*, Mu'assasat Dār al-Turāth, Cairo, n.d., vol. 5, p. 191.

and silver and has the same rules regarding *zakah* or exchange for one another. Thank Allah that the *sharī'ah* adviser of the Kuwaiti Finance house had an opinion similar to that of the Board of Great Scholars in Saudi Arabia. It is reported in resolution no. 10, dated 16/4/ 1393.A.H. of that Board, "After examining the different opinions of experts of economics on the subject, the following *fatwā* was issued: "Considering the fact that money is everything considered by custom as a medium of exchange, as it is said by Ibn Taymiyyah, then there is no natural or legal specification of what should be the medium of exchange. The acceptance of any medium of exchange depends on custom and usage. Thus, the *dirhams* and the *dinārs* are not desired for their own sake but because of their ability to serve as a medium of exchange.¹⁶ Imām Mālik is also reported to have said in the *Mudawwanah*: "If people used camel skin as a medium of exchange I would see it as unlawful to exchange it with gold on a deferred basis."¹⁷ Therefore, since paper money is generally accepted as a medium of exchange and source of value, and since it is not a certificate which could be refunded by gold, and given the fact that it is not necessary to be wholly backed by gold later, the strength or weakness of any currency depends on the economy of the country of its origin. Therefore, it should be considered in the same way as gold.

The opinion of Imam Mālik¹⁸ and Imām Aḥmad Ibn Ḥanbal¹⁹ that the *'illah* in gold and silver is *muṭlaq al-thamaniyyah* (broader concept of money) seems to be in line with the objective of *sharī'ah*, and since this *'illah* is present in paper money, the Board of Great scholars decided by a majority that paper money is a *thaman* and it differs according to the country of issuance. Therefore, *ribā* is applicable to these currencies as it is to gold and silver or others like *fulūs* (cheap metal or copper money). It is not permissible to sell them on a deferred basis or to exchange one kind of it with another with an addition, such as selling ten Saudi *riyāl* (paper) for eleven (coin). However, it is permissible to exchange these different currencies if it is hand to hand. *Zakah* is obligatory on paper money and it can be made the price for *salam* and partnership contracts.

¹⁶ Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 19, pp. 250–252.

¹⁷ Malik Ibn Anas, *al-Mudawwanah al-Kubra*, vol. 3, p. 90.

¹⁸ al-'Adawī, *Hāshiyat al-'Adawī*, Dār al-Fikr, edited by Yousouf al-Sheikh, Dār al-Fikr, Beirut, 1982, vol. 2, p. 45.

¹⁹ Ibn Qudāmah, *al-Muqni*, vol. 4, p. 5; Ibn Taymiyyah, *al-Fatāwā*, vol. 29, p. 137.

Based on the above, the *sharī'ah* advisor of the Kuwait Finance House argued, "We are of the opinion that trading gold and silver, whether bullion or otherwise and whether it is exchanged with paper money, gold or silver must take place at the place of the contract, determined according to the custom of the day. Therefore, receiving a cheque could be considered taking of possession at the time of contract and it is similar to paper money in circulation and taking possession.

Commenting on the opinion of some commentators on the issue, the *sharī'ah* adviser pointed out that some have noted a difference between the imposition of *zakah* and the possibility of *ribā* in paper money if it is transacted on a deferred basis. They considered paper money as something that should be subjected to *zakah* but not *ribawī*. This is an odd differentiation since paper money should be considered as gold and, therefore, it should be subjected to *zakah* and the rules of taking possession. Otherwise, it should be considered as a commodity and by consequence not subjected to *zakah* unless it is used for trade. This last possibility is unacceptable due to its impacts on *zakah* and *ribā*. It is commonly accepted that people do not keep paper money for trade but as a medium of exchange for their needed commodities. They do not consider it as a commodity. Therefore, to consider it as such would mean it is legitimate to exchange ten *dīnārs* for eleven and this is direct *ribā*.

Pursuing his analysis the *sharī'ah* advisor said, "Concerning the status of other metals, the jurists have different opinions as to whether an analogy with gold could be accurate. The Zāhiri school,²⁰ Osmān al-Butti, Ibn 'Aqīl from the Ḥanbali school,²¹ Qatāda and Tawūs from the *Tabi'ūn* regarded the 'illah or the rationale to be limited to the items mentioned in the *ḥadīth*. However, we do not need to elaborate on the different opinions regarding the 'illah since Muslim jurists are unanimous that if these metals are exchanged with paper money, there is no *ribā* whether *nasī'ah* (loan) or *faḍl* (trade). Therefore, it is possible to sell it at the spot or on a deferred basis if one of the countervalues is present. Otherwise, it will be *bay' al-kālī' bi al-kālī'*."²²

²⁰ Ibn Ḥazm, 'Alī Ibn Aḥmad, *al-Muhallā bi al-'Āthār*, Dār al-Ma 'ārif al-Jadīdah, Beirut, vol. 8, 1988, pp. 471–478.

²¹ Al-Mirdāwī, *al-Inṣāf*, Dār Iḥyā' al-Turāth, Beirut, vol. 5, pp. 131–135.

²² Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtisādiyyah*, pp. 553–559.

It is clear that even this answer is not convincing with regard to the issue of gold trading. First of all, the answer is entirely based on the *fatwā* of the Board of Leading Scholars in Saudi Arabia, which was about the issue of considering paper money as a medium of exchange and source of value like gold. If this is so, then paper money should fall under the same ruling as gold concerning *ribā* and *zakah* and it is not at all about gold trading. Still, some similarities do exist between the two issues, but they are not the same. Therefore, a correct conclusion based on the analysis of one of them would not be correct for the other. Secondly, the *sharī'ah* advisor raised the issue of *'illah*, but not in connection to gold, the topic under discussion, but about other metals. A thorough investigation of the *'illah* of gold may lead to another conclusion. Moreover, he mentioned only the opinion of the literalists or the *zāhiri* school, who considered the *'illah* to be limited to the items mentioned in the *ḥadīth*. Therefore, paper money could not be considered as *ribawī*, which in turn contradicts his conclusion about paper money based on the view that the *'illah* in gold and silver is *mutlaq al-thamaniyyah* (broader concept of money).

The issue was discussed again at the Kuwait Finance House between Mohammad Abū al-Saud, Aḥmad Bazī al-Yāsin, the president of the House, and Sheikh Badr al-Mutwallī 'Abd al-Bāsit. Mohammad Abū al-Saud maintained that today gold is considered a commodity like any other commodity and that paper money is considered as legal tender not because they are backed by gold or silver but because of the authority of the law. Second, paper money represents the total output of goods and services produced by the country, and last, people needed it as a medium of exchange. Therefore, exchanging gold with any kind of these paper currencies is like any ordinary sale that could be deferred.

Sheikh Badr al-Mutwallī 'Abd al-Bāsit replied that based on his personal knowledge, it is necessary that any kind of paper money be backed by a certain quantity of gold in most countries around the world. Therefore, the rules regulating *ṣarf* should be maintained in its exchange and the taking of possession should be at the time of the conclusion of the contract.

Aḥmad Bazī al-Yāsin supported Sheikh Badr's view that paper money must follow the rule for gold and silver with regard to the issue of taking possession in exchange and *zakat*. Otherwise, he argued, this would open the doors for *ribā*. Finally, Sheikh Badr pointed out that a final decision on the subject should be discussed at the level of "leading scholars" given the complexity of the subject and the diversity of

opinions on the matter. Therefore, a single scholar could not give a conclusive ruling on the subject.²³

A close look shows again that the discussion concentrated on a part of the problem, namely, what is the right ruling that should be assigned to paper money and whether it should be the same as the rulings pertaining to gold or not.

Almost the same question was addressed to the *sharī'ah* board of Faisal Islamic bank of Sudan and the answer was the same concerning the deferred deal if the agreement is considered as a contract. However, the board went on to say that if the agreement is considered just a promise, which would be confirmed later on by a contract, the transaction is valid; but if the promise was the only agreement, then the transaction is illegal.²⁴ On the other hand, the board remarked that "it may be said that gold has lost its characteristic of *thamaniyyah* or measurement of value and medium of exchange and has become nowadays a commodity like wheat and dates. Then why should it not be exchanged with paper money on a deferred basis as it is the case with wheat and dates? It had been permissible, from the beginning, to exchange *ribawī* items such as wheat and dates with gold when it was a medium of exchange on a deferred basis. In other words, there was no legal problem in exchanging these *ribawī* items with the prevailing medium of exchange, which was gold at that time. Indeed, the issue merits discussion in order to ascertain if gold had really lost its *thamniyyah* or measurement of value and medium of exchange and had become a commodity like any other commodity. Second, we have to look into the interpretation of Ubādah Ibn al-Sāmit's *ḥadīth*, "If these commodities differ, then you may sell as you wish, provided that the exchange is hand to hand." The literal interpretation of this *ḥadīth* shows that it is not permissible to trade any of these six mentioned items if they differ, unless it is hand to hand. This means it is not permissible to exchange wheat or dates with gold on a deferred basis. Nonetheless, Muslim scholars are unanimous that it is legal to do so.

Therefore, is it possible for contemporary Muslims jurists to conclude that it is permissible to exchange gold with dollars, for instance, on a forward basis because the dollar has replaced gold as a medium

²³ Ibid., pp. 559–560.

²⁴ Faisal Islamic Bank of Sudan, *Fatāwā Hai'at al-Raqābah al-Shar'iyyah Li-bank Faisal al-Islāmī al-Sudānī*, pp. 95–97.

of exchange and gold has become a commodity like wheat or dates, although it is still a *ribawī* item? The issue needs considerable research and attention and we believe that it should be discussed by the respective *sharī'ah* boards of Islamic banks and financial institutions and then by the supreme *sharī'ah* board for a collective decision. However, until this decision is issued, the board relies only on the literal meaning of the *ḥadīth* in its present *fatwā* as it is explained above.²⁵

Based on the different arguments discussed above and the contradictory interpretations, the present study will attempt to address this issue. First of all, it should be noted that there is no specific *sharī'ah* provision on what the medium of exchange should be as we already mentioned in Ibn Taymiyyah's statement. Moreover, there is no specific provision in the Qur'ān or the sunnah that would make it incumbent upon the Muslim *Ummah* to use continually the bimetallic standard of gold and silver, prevailing in early Islamic history. This is clearly demonstrated by the fact that 'Umar, the second Caliph, once thought of introducing camel skin coins. This would have been in the nature of fiduciary money, which is equivalent to the now-prevailing paper money. However, the problem that might have perplexed him was probably the control of its issuance when he was advised by experts that it would be impossible to do this and it might not only lead to excessive creation of money but also the disappearance of camels through their excessive slaughter. He then abandoned the idea. The idea has also been generally reflected in the writing of a number of prominent Muslim jurists. We have already mentioned above the opinion of Imam Mālik and Ibn Taymiyyah. Also Aḥmad Ibn Ḥanbal is reported to have said that there is no harm in adopting as currency anything that is generally accepted by people.²⁶ Ibn Ḥazm also did not find any reason for Muslims to confine their currency to gold or silver.²⁷

However, the issue under discussion, namely, gold trading with paper money on a deferred basis, cannot be resolved unless we explore briefly the *'illah* for which the *sharī'ah* has prohibited the exchange of gold and silver, unless they are of equal measurement, quality, and delivered hand to hand.

²⁵ Ibid., p. 98.

²⁶ al-Ruhaibānī, *Matālib ulī al-Nuhā fi Sharḥ Ghāyat al-Muntahā*, vol. 3, p. 181.

²⁷ Ibn Ḥazm, *al-Muḥallā bi al-Āthār*, vol. 5, p. 351.

The 'illah behind Trading Gold unless Its Hand to Hand

Despite the fact that almost all Muslim schools except the Zahirī school used analogy to widen the scope of *ribā* in gold and silver, they often dissented when it came to the practical interpretation of the *ḥadīth*. Thus, the Zahirī school, as a result of their rejection of analogy (*qiyās*) as a way of determining the law, assumed that the prohibition of *ribā* applies only to the six articles quoted in the *ḥadīth* (gold, silver, wheat, barley, dates and salt). Therefore, it cannot be extended by way of analogy to other articles.²⁸ A direct consequence of this opinion was that paper money would not be considered as having the characteristic of gold and silver as mentioned in the *ḥadīth*. Therefore, it is legal to exchange them with paper money on a deferred basis. It seems that the International Association of Islamic banks has adopted a similar interpretation in its opinion as quoted above. We have already mentioned its shortcomings and their grave consequences on *ribā* and *zakah*.²⁹

For the Ḥanafīs the *'illah* is that they are weighed articles when they are exchanged.³⁰ This opinion has also been attributed to Imām Aḥmad Ibn Ḥanbal as one version of his opinion.³¹ On the other hand, for the Mālikīs, Shaf'īīs and a second version of Imam Aḥmad's opinion, the *'illah* in gold and silver is that they are currency (*athmān*). However, some of them considered the *'illah* here as totally restricted to gold and silver and could not be extended to any other thing (*'illah qāsirah*). The last opinion was reported from some Mālikīs³² and Ḥanbalīs³³ who maintained that the *'illah* in gold and silver is that they are currency (*athmān*). A similar analysis was also reported from Mohammad Ibn al-Ḥassan al-Shaibānī in his discussion of the possibility of *ribā* in *fulūs*.³⁴

²⁸ Ibid., vol. 5, p. 355.

²⁹ See also 'Ali al-Sālūs, *Al-Nuqūd wa Istibdāl al-'Umlāt*, Maktabat al-Falaḥ, Kuwait, 1985. 'Ali al-Sālūs elaborated on this in his argument and counterargument with Ḥassan Ayyoub. While Sālūs maintains that the *'illah* is *mutalq al-thamaniyyah*, Ḥassan Ayyoub is of the opinion that the *'illah* is restricted to the six items mentioned in the *ḥadīth*; therefore, there is no *ribā* in the exchange of papers currencies on a deferred basis because they are commodities.

³⁰ Al-Sarakhsī, *al-Mabṣūt*, vol. 12, pp. 167–8.

³¹ Ibn Qudāmā, *al-Mughnī*, vol. 4, p. 125.

³² Imām Mālik, *Al-Mudawwanah*, vol. 3, pp. 395–396.

³³ Ibn Qudāmā, *al-Mughnī mā'al-Sharḥ al-Kabīr*, vol. 4, p. 126. Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, pp. 251–252.

³⁴ See al-Sharakhsī, *al-Mabṣūt*, vol. 194.

Moreover, this *'illah* could be extended to any other object, which has become a medium of exchange (*mutlaq al-thamaniyyah*).³⁵

However, to consider the rationale (or unique feature) prohibiting *ribā* in gold and silver to be the weight is somehow inconsistent. For instance, it is agreed among all scholars that it is permissible to make a *salam* contract in exchange for other weighable items. Therefore, if we consider gold and silver as weighable items, we would be exchanging weighable with each other on a deferred basis, which would undermine the very objective of the *'illah* itself. Moreover, if we look to the wisdom behind the prohibition of *ribā*, it could be said that it is more apparent, nowadays, in paper money than it is in gold, although it is not a weighable item.³⁶ However, some Ḥanbalis who adopted this view argue that other weighable items are accepted in *salam* without *ribā* by way of necessity. The weakness of this argument is clear.³⁷ The Ḥanafīs for their part, argued that gold is weighed on scales while other weighable items are measured by the steelyard.³⁸ This argument is even weaker than the first one.

On the other hand, there is greater consistency in the argument of those who consider *thamaniyyah* as the *ratio* or important feature in gold and silver. However, they too have differed among themselves as we have mentioned before. Some considered it *qhalabat al-thamaniyyah* which means the *thamaniyyah* in gold and silver occurs by nature or creation (*bi al-khilqah*). In other words, these two commodities are by creation the only medium of exchange and should remain so. Moreover, no other item could be given these characteristics.³⁹ A direct implication of this opinion is that they have classified money into natural money (*naqd bi al-khilqah*) and conventional money (*naqd Iṣtilāḥī*). The former represents bullion money because, as they argued, gold and silver were created by Allah to act as the price. The latter, namely, conventional money, represents all forms of money whether made of inferior metal

³⁵ See al-Shawkānī, *Nayl al-Awtār Sharḥ Muntaqā al-Akhbār Min A ḥadīth Sayyid al-Akhyār*, Cairo, al-Bābī al-Ḥalabī, vol. 5, p. 220.

³⁶ For more detail, see 'Abd Allāh Ibn Manī, "al-Waraq al-Naqdī Ḥaqīqatan wa Hukman," *Buḥūth fi al-Iqtisād al-Islāmi*, Saudi Arabia, Idārat al-Thaqāfa wa al-Nashr, Jāmi'at al-Imām Muḥammad Ibn Sa'ūd al-Islāmiyyah, 1989, pp. 59–107.

³⁷ See Ibn Qudāmah, *al-Muqhnī*, vol. 4, p. 4.

³⁸ See al-Kasānī, *Badāi al-Sanāi*, vol. 5, p. 186.

³⁹ Al-Bājī, *al-Muntaqā Sharḥ Muwata' al-Imām Mālik*, vol. 4, p. 258; al-Ghazālī, *Ihyā' 'Ulūm al-Dīn*, vol. 4; p. 96; al-Nawawī, *al-Majmū' Sharḥ al-Muhazzab*, vol. 9, p. 443.

or paper or any other commodity. The former is money par excellence; the latter is only taken as money.

This classification has, in fact, led to two conflicting conclusions. For some jurists, nonbullion money like *fulūs* (cheap metal or copper money) is not to be treated as real money having a natural value. Consequently, any excess in exchange of *fulūs* whether on the spot or in deferred payment does not fall under the purview of prohibited *ribā* and they are not subject to *zakah*.⁴⁰ If we apply this argument to paper money in exchange for gold, on a deferred basis, there will be no legal problem. However, this opinion is based totally on the reverse of the reality of our modern times, where paper money is the sole medium of exchange and store of value, while nobody uses gold as a medium of exchange. Moreover, to consider these different kinds of paper money as non-*ribawī* items would open the doors to *ribā* and undermine the objective of the *sharī'ah*.

However, the second group of those who considered the *'illah* to be *al-thamaniyyah* maintained that it is *mutlaq al-thamaniyyah*, which means that whatever item is considered as a medium of exchange by custom and widely used by people for that purpose will be a *ribawī* (related to *riba*) item. This opinion was reported from the different schools of Islamic law and vigorously defended by Ibn Tamiyyah and Ibn Qayyim.⁴¹ Pursuing the same line of argument Ibn Tamiyyah and Ibn Qayyim maintained that even jewelry made of gold and silver could be exchanged on a deferred basis. This is because it is no longer *athmān* or a price or medium of exchange but rather a kind of commodity. Some modern Muslim commentators have also defended this stand. Thus, Sa'dī Abū Jayb argues that it is custom that has given gold and silver the characteristic of being the medium of exchange and it is the same custom that has deprived them of this characteristic and replaced them with paper money. Even the gold and silver coins used previously as the medium of exchange are no longer used as such and they could be transformed into jewelry without any legal problem ensuing.⁴²

⁴⁰ Nazih Hammād, "Taḥawwūr al Nuqūd wa Atharuhu 'alā al-Duwūn fi al-Fiqh al-Islāmī," *Majalat al-Baḥth al-'Ilmī*, Jeddah, vol. 3, 1980; Hasnuz Zaman, *Indexation of Financial Assets: An Islamic Evaluation*, The International Institute of Islamic Thought, Islamabad, 1993, p. 49.

⁴¹ See Ibn Rushd, *Bidāyat al-Mujtahid wa Nihāyat al-Muqtaṣid*, vol. 2, p. 97; Ibn Qayyim al-Jawziyyah, *'Ilām al-Muwaqqi'n an Rab al-Ālamīn*, vol. 2, p. 156; Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 472.

⁴² Sa'dī Abū Jayb, *Bay' al-Ḥulīi fi al-Sharī'ah*, Dār al-Fikr al-Mu'āsir, Beirut, 1994, pp. 3–18.

More importantly, the prohibition on exchanging gold or silver on a deferred basis is not because it is gold or silver but because they are the price and medium of exchange. But when they are in the form of jewelry, they no longer represent a price. Therefore, their exchange could be transacted on a deferred basis.

*The Effect of the 'illah in Gold to
Its Trade on a Forward Basis*

The question here is that if paper money is the sole medium of exchange recognized by people around the globe, and if the consistent 'illah behind the trade of gold and silver on a deferred basis no longer exists nowadays, and considering the fact that one of the well-recognized Islamic jurisprudential principles is that the existence of any rule is subject to the existence of its cause or 'illah (*al-ḥukmu yadūru ma' illatihi wujūdan wa 'adaman*), what would be the position of gold and silver? Moreover, if we consider the argument advanced by Ibn Taymiyyah and his disciple Ibn Qayyim with regard to the permissibility of exchanging jewelry on a deferred basis since it is no longer a medium of exchange, and the opinion that *fulūs* are *ribawī* items because they are *athmān*, one could say that the logic and legal arguments advanced in favor of the permissibility of selling gold and silver today on a deferred basis require strong argument and evidences in order to be overruled. We have already explained the weaknesses of the different kinds of 'illah advanced by the different schools and their result of opening the doors to *ribā*, except for the opinion that the 'illah is *mutlaq al-thamaniyyah*. We could say that the prohibition against selling gold and silver on a deferred basis is not because they are gold or silver but because they are *athmān*, or the medium of exchange and whatever the custom considers it must be, so that it should be treated as *thaman*. On the other hand, the reality is that neither gold nor silver is *thaman* nowadays, and the Islamic principles are clear with regard to a specific rule if its 'illah is no longer in existence.

Despite this reality and the legal argument advanced, the views of some commentators raise concern. Saleh al-Marzūqī argued, for instance:

The use of paper money is well established in the Muslim world and has become the only medium of exchange or almost so, because it possesses the 'illah behind the prohibition to transact gold and silver on deferred bases, which is *thamaniyyah* as recognized by the *Fiqh* Academies and the Council of Great Scholars in Saudi Arabia and accepted by most

contemporary Muslim jurists. Despite the fact that the use of gold as a medium of exchange has totally disappeared except in limited circumstances, some countries have even prohibited its use as a medium of exchange and the fact that bullion gold is traded as commodity, the *thamaniyyah* in the old golden *dinār* will remain and must remain so until the day of judgment. In addition, the appearance of paper money nowadays, or another medium of exchange in the future, will not change the *thamaniyyah* in gold whether it is in the form of *dinār*, bullion, jewelery or raw gold because the sunnah makes it an obligation that it should not be traded unless of equal measurement and exchanged hand to hand. It is the basis (*ʿasl*) on which other items will be considered by analogy.⁴³

It is clear from this argument that al-Marzūqī was of the opinion that gold and silver are *athmān* by creation or by nature, which means gold and silver will remain *athmān* even if they lose their characteristic of being the medium of exchange or *athmān* in real life. They must remain as *athmān* because they are so by nature. However, despite the fact that some classical scholars have argued that gold and silver are *athmān* by nature and that this opinion has been endorsed by some contemporary writers, we have not come across the legal basis for this opinion in the Qurʾān or the sunnah. Therefore, to our knowledge, there is no such basis except *ijtihād* (endeavour of a jurist to derive a rule). And if it is merely an *ijtihād* we are not under any obligation to follow it, especially when it contradicts another kind of *ijtihād* that seems to be more rational and consistent. It should be noted that Salamah Jabar, one of the advocates of the view that gold and silver are currencies by creation, quoted a *ḥadīth*⁴⁴ to justify his claim. The *ḥadīth* is reported in al-Tabarānī to the effect that “gold and silver are the stamp of God on earth and whoever brings this stamp will get his need fulfilled.”⁴⁵ However, this is a weak *ḥadīth*⁴⁶ and could not be accepted as an argument on the issue. Moreover, even the meaning seems to have no connection with the claim that gold is money by creation. It is well recognized that *aḥkām* or Islamic rules in the area of *muʿamalāt* (commercial transac-

⁴³ Saleh al-Marzūqī “Tijārat al-Zahab fi Aham Ṣuwarihā wa Aḥkamihā,” *Majallat Majmaʿ al-Fiqh al-Islāmī*, ninth session, no. 9, vol. 1, 1996, pp. 152–153.

⁴⁴ Moḥammad Salāmah Jabar, *Aḥkām al-Nuqūd fi al-Sharīʿah al-Islāmiyyah*, Maktabat al-Ṣaḥwah al-Islāmiyyah, Kuwait, 1995, p. 111.

⁴⁵ *Al-danānir wa al-darāhim khawātim Allāh fi ʿardihi faman jāaʿ bi khatami mawlāh quḍiyat ḥājatuhtu*.

⁴⁶ See al-Manāwī, Moḥammad ʿAbd al-Rauf, *Fayd al-Qadīr Sharḥ al-Jāmiʿ al-Ṣaḥīr min Aḥādith al-Bashīr al-Nazīr*, Dār al-Kutub al-ʿIlmiyyah Beirut, Lebanon, 1994, vol. 3, p. 726, *ḥadīth* no. 4268. Al-Haithami said one of the reporters of this *ḥadīth* is Aḥmad Ibn Moḥammad Ibn Mālik Ibn Anās. He is not a reliable person (*daʿīf*). Al-Zahabī said this is a weak *ḥadīth*. Ibid.

tions) are based on reason or *ta'lil*. To claim that the *thamaniyyah* in gold and silver is natural or by creation is to contradict this principle without real evidence.

Another commentator who shares the view of al-Marzūqī is Sāmī Ḥammūd. He stated that

No consideration shall be given to the opinion that the status of gold and silver has changed from being medium of exchange to merely commodities. Our response is that, any issue in Islamic law, the rule of which has been stated in the text, would not change even if the circumstances change. Thus, gold and silver are still maintaining their status of *thamaniyyah* although they are not used nowadays as a medium of exchange. The Prophet (PBUH) made no distinction between bullion and gold coin at the expedition of Khaibar and there is no consideration to the change of use of these items. And no one could argue that we (people in the Middle East or Jordan) are no longer eating wheat and people in East Asia are not eating wheat but rice, then wheat is no longer a *ribawī* item and could be exchanged on a deferred basis. This is an important point for those who are thinking to be involved in the international markets and trade on forward and futures basis in gold, silver, currencies and commodities, which are *ribawī* on forward and future basis.⁴⁷

It seems that this argument is based on the assumption that the prohibition of trade in these items on a deferred basis is not based on any *'illah*, as it is claimed by the Zahiri School or the opinion that gold and silver are *athmān* by creation. Then they will remain so even if they are no longer *athmān* in real life. We have already pointed out the shortcomings of this argument. Furthermore, the changes of circumstances do have an effect if the *'illah* is no longer in existence. If we consider the prohibition of these items to be based on *'illah*, then rice will take the rules of wheat with regard to *ribā*. It is an edible food commodity and can be conserved therefore, the argument advanced by Ḥammūd in this regard has no place in our discussion. In addition, if wheat were not used in some part of the world or a specific community ceased to use it, this would not mean that it is not in use in all parts of the world. Many people are still using wheat, which is not the case with gold, as it has totally disappeared as a medium of exchange.

To sum up our discussion on gold and the possibility of selling it on a deferred basis, one can say if gold and silver are no longer *athmān*, as it is argued by many, then, does their rules about *ṣarf* in particular shall

⁴⁷ Sāmī Ḥassan Aḥmad Ḥammūd, “‘Amal al-Ṣarf wa Tabādul al-‘Umulāt wa ‘Aḥkamuha fi al-Fiqh al-Islāmī”, *Abḥāth al-Mu'tamar al-Thānī li al-Maṣrif al-Islāmī*, Kuwait, 1983, p. 111.

be maintained and on any grounds be maintained. This is because many scholars such as al-Kāsānī define *ṣarf* as “the exchange of *athmān* with each other.”⁴⁸ Therefore, does this mean if gold and silver are exchanged with paper money the transaction is not a *ṣarf* transaction? However, if they are exchanged with each other, it should be hand to hand as it is a case of *sarf*. Similarly, with reference to other items mentioned in the *ḥadīth*, such as wheat and dates, which could be exchanged with currency on a deferred basis without any legal problem, they could not be exchanged with each other unless it is hand to hand.

It is noteworthy nevertheless that despite the result of the above analysis, we could not claim that our conclusion is a final one. However, given the fact that the issue is of great importance to Muslim investors and more importantly in establishing a clear concept of money in Islamic modern Islamic economy, the issue needs to be investigated urgently. We have attempted to tackle the issue, nonetheless. Due to the sensitivity and complexity of the issue, a single study may not be enough to reach a final conclusion and a collective effort is needed. On the other hand, the above conclusion and arguments will be maintained if in practical life gold has really lost its characteristic of *thamaniyyah*. Yet, this will be a practical and economic dimension of the problem and not a legal one. Therefore, if gold is still a *de facto thaman* as it is maintained by some Muslim economists, the exchange of gold or silver with paper money should be hand to hand.

From a practical point of view, and despite the general view that gold is no longer apparently a medium of exchange and store of value nowadays, some Muslim economists are still maintaining that gold has not totally lost these characteristics. Thus, El-Gārī⁴⁹ argued in favor of the indexation of debt using gold rather than other instruments: “Many people believe that gold nowadays is just a commodity like any other without any special characteristic. Therefore, its relation with currencies is similar to the relation of any other commodity, such as petroleum, wheat, or any other commodity traded in the international market. Moreover, the time when gold is considered as a currency is already over and the attachment of some people to gold in this area is no more than an emotional feeling.” However, this is not completely correct.⁵⁰

⁴⁸ al-Kāsānī, *Badāi al-Ṣanāi fi Tartīb al-Sharāi*, vol. 7, p. 3181.

⁴⁹ Mohammad Ali El-Gārī, “Kasād al-Nuqūd al-Waraqīyah wa ‘Inqitā’ihā wa Ghalā’ihā wa Rakhaṣīhā wa ‘Atharu zālīka fi Ta’yīn al-Ḥuqūq,” *Majallat Majma’ al-Fiqh al-Islāmī*, no. 9, vol. 2, pp. 694–697.

⁵⁰ Ibid.

1. Gold is still the origin of many currencies and they gained acceptance and circulation because of it, although this relation is no longer obvious. However, gold still has its special position and nature that differentiate it from other commodities. It is still more closely related to currencies than to other consumable or industrial commodities. For instance, people used gold as a medium of exchange 3000 years ago and it remained so in one way or another until 1971 when the United States ended the convertibility of the dollar to gold. Despite this fact, gold remains the best measurement of value, albeit in an indirect way, in contemporary transactions. Measurement of value in particular is still based on the gold system as it is explained below:
 - The price of one ounce of gold was thirty-five dollars when the United States moved out of the gold system. Today, this price has increased tenfold. It is now 350 dollars per ounce. However, what attracts attention is that other financial indices have increased to this level, namely, ten times. Thus, the public debt in the United States has increased ten times, as well as the cost of the public debt, or the rate of real interest etc. All this shows that gold is still in reality the “currency by creation.”
 - The strongest currencies in the world today are those that have been able to have a stable relation with gold despite the absence of an official relation between gold and these currencies. For instance, Japan is always eager to maintain stable relations between gold and the Yen. For that reason the price of gold has increased three times vis-à-vis the Yen since 1971. Moreover, the Japanese monetary policy is based on the maintenance of a stable relation between the Yen and gold.
 - Gold is still the best indicator of price movements in the future... and the United States has been able to establish a stable price movement after the adoption by the Federal Reserve System of gold as the base of monetary policy.
2. Many experts, especially those associated with the Federal Reserve, believe that a stable monetary policy cannot be realized unless the major currencies around the world are related to gold in one way or another. Even the Federal Reserve chairman has also backed this opinion. All these facts show that gold is the “natural currency.”
3. Most banking legislation around the world prevents banks from trading in commodities like wheat, oil, phosphate, aluminium etc., because banking activities are limited to currency trading. However, this legislation includes gold in the category of currencies and allows banks to invest in them.

4. Gold has special characteristics compared to other indicators or commodities. Other commodities may be extinguished through consumption and their supply is based on today's consumption, while the supply of yesterday has already been consumed. This is not the case with gold where today's supply is the supply of gold available on earth since man discovered gold. Since the supply of gold is always increasing, this will result in its greater independence from the control of a specific body.
5. The world production of gold will not add to the existing quantity by more than two percent annually. This means a stable supply of gold, which consequently, means the stability of the currencies backed by gold. This is not the case with paper money, where the governments and banks can create unlimited amounts of money.⁵¹

It is clear from this analysis that in El-Gārī's view gold is currency by nature or by creation. However, as we have already mentioned, although some classical Muslim jurists have opted for this opinion, there are no reliable legal grounds for it. If gold is currency by creation, is it permissible for Muslims, especially in modern times, to use other items as currency and reject gold? If the answer is positive, then, the opinion that gold is currency by creation is of no legal effect. However, if the answer is negative, then, the Muslim *Ummah* (the Muslim community) would be committing a sin by rejecting the use of gold. But such a conclusion has never been articulated nor supported by any Muslim jurist. Moreover, gold and silver are not used by any community around the world as medium of exchange to purchase valuable or non-valuable goods.

Therefore, we can maintain that gold and silver have been mentioned by the *sharī'ah* texts just because they were the currencies in use at that time. Moreover, the assertion that gold is currency by creation is not sustained by historical evidence as many nations throughout history have stopped using it for that purpose. Further, these arguments advanced by al-Gārī would be totally correct if they could also be applied to silver, the other metal used at the time of the Prophet (PBUH) as a medium of exchange and explicitly mentioned in the *ḥadīth*. Moreover, the two metals have the same rules throughout Muslim legal history and therefore, if they are by creation currencies, they should remain so together or disappear together. But if they are not currencies by creation, we could say they were the medium of exchange during the time of the

⁵¹ Ibid.

Prophet (PBUH) because the custom was so at that time. Later on, silver lost this characteristic and gold has become the sole medium of exchange and store of value and now this too has been totally replaced by paper money. Therefore, the determining factor in the issue is the custom and whatever item is used by people as currency. There is thus nothing special in the substance of *dirham* and *dinār*, as Ibn Taymiyyah has explained.

Ibn Manī, a contemporary jurist who has written widely on the subject of currencies and gold and is a member of the different Islamic *Fiqh* Academies, said in his rebutal of the claim that gold and silver are money by creation:

We have doubt about the reliability of the opinion that gold and silver are money by creation. This doubt will be more apparent when we survey the history of money, which reveals that people had different kinds of money before gold. The concept of money is a subjective concept. It could vary according to government policies and according to custom and practice. Therefore, the opinion that gold and silver are money by creation is just an opinion, which has no grounds either from legal, or linguistic or historical perspectives. However, this does not deny the fact that it has more characteristic of *thamaniyyah* than any other item.⁵²

Given the above argument and counterargument and the confusion whether gold has lost its characteristic of *thamaniyyah* or not and despite the conviction that gold is not currency by creation, the present study is somehow reluctant to give a final verdict on the issue due to the practice of certain developed countries having policies totally related to gold or the international practice of allowing banks to trade in gold although, in principle, their area is limited to currencies. This may shadow the stand that gold has totally lost its characteristic of *thamaniyyah*. However, a temporary solution to the issue of trading gold on a deferred basis will be the idea of non-binding mutual promise to exchange gold with paper money at the spot price followed by a contract to confirm it at the time of delivery based on the argument that gold is still money and *thaman*. The idea will be elaborated in the next chapter because it is generally discussed as one of the alternative for risk management of currency.

However, if the controversy about trading gold on a deferred basis is still debated, what is the Islamic position on trading currencies on a forward basis? This is what will be discussed next.

⁵² ‘Abd Allāh Ibn Manī, “Al-Zahab fi Ba’ḍi Khaṣā’iṣhi wa Aḥkamihi,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1996, no. 9, vol. 1, p. 76.

CHAPTER FOUR

THE FORWARD MARKET FOR CURRENCIES

Basic Rules of Currency Exchange and Paper Money

Before starting our discussion on the legality of forward currency markets in Islamic law, it is necessary to establish the legal status of modern currencies in Islamic law. Do they invoke the rules of gold and silver as the medium of exchange and source of value or they are like *fulūs* (cheap metal or copper money) known to early Muslim jurists or something totally different? The issue has been discussed in several forums such as that of the Islamic Fiqh Academy based in Makkah, the Board of Great Scholars in Saudi Arabia, and the Islamic *Fiqh* Academy based in Jeddah.¹ Each institution has passed a resolution on the subject. However, one of these resolutions may be enough to clarify the issue since there is a great similarity between these different resolutions. The major points of the resolution adopted by the Islamic *Fiqh* Academy based in Makkah were as follows:

1. Considering that gold and silver were the principle medium of exchange, and the *'illah* of *ribā* in these two metals was *mutlaq al-thamaniyyah* (the broader characteristic of being money) or money and the medium of exchange, then according to the most authoritative opinion of Muslim jurists, this *'illah* is not restricted to these two metals, although they represented the principle source. On the other hand, considering that paper money has become *thaman* and replaced gold and silver in their use today, it is through these currencies that the value of things is measured after the disappearance of the gold and silver standards. Moreover, people rely on and keep paper money as a store of value. Debt is settled by these currencies, despite the fact that their values are not intrinsic but based on their acceptance as medium of exchange; by this characteristic they become a *thaman*. Considering the fact that the *'illah* in gold and silver is the

¹ See Majma' al-Fiqh al-Islāmī, *Majallat Majma' al-Fiqh al-Islāmī*, no. 3, vol. 3, p. 165. Resolution no. 21 (9/3).

thamaniyyah, which is also present in paper currency, the Academy decided that paper money is an independent kind of medium of exchange. It has the rules of gold and silver concerning *zakah*, *ribā al-faḍl* (riba related to trade and *ribā al-nasīʾah* (related to loan) as it is in gold and silver by way of analogy based on *thamaniyyah*. Thus, paper money will follow all rules related to gold and silver regarding *sharīʿah* obligations.

2. Paper money is considered an independent kind of currency as is the case with gold and silver. These different currencies should be considered as different types of currencies according to the country of issuance. In other words, the Saudi currency is a kind (*jins*) and the American currency is another kind (*jins*) and so on. Therefore,
 - *Ribā*, whether *faḍl* or *nasīʾah*, applies to these currencies as it does to gold and silver. Consequently, it is illegal to buy and sell these currencies in exchange for one another or for gold and silver on a deferred basis without taking possession at the time of the contract.
 - It is illegal to exchange the different tenders of any of these currencies with each other whether in a spot market or on a deferred basis. For instance, it is illegal to sell ten Saudi riyal for eleven on the spot or on a deferred basis.
 - It is legal to exchange these currencies if the transaction is conducted on the spot. For instance, it is legal to exchange two Lebanese lira with two Saudi riyal or more or less or an American dollar with three Saudi riyal or more or less if it is hand to hand. Also, it is legal to exchange three Saudi paper riyal with three Saudi silver riyal or more or less, if it is on the spot, because they are not from the same kind (*jins*).
3. *Zakah* the amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy) on paper money is obligatory if its value reaches the amount prescribed by the *sharīʿah* for silver and gold. But it should be based on any cheaper price of the two metals. If there are some commodities for trade, besides gold or silver, it should also be added as subject of *zakat*.
4. It is legal to use paper money as a price for *salam* and capital for partnership.²

² See *Qarārāt Majlis al-Majmaʿ al-Fiqhī al-Islāmī*, Makkah 8 to 16, Rabi al-Ākhir, 1402, Fifth Session, pp. 96–97.

Thus, the spot currency exchange is unanimously agreed upon among Muslim jurists as a legal one. The majority of contemporary Muslim jurists, on the other hand, consider the forward exchange as illegal. This is also the position of the major Islamic institutions interested in Islamic commercial law. However, some scholars have argued for its legality by drawing an analogy with *fulūs* or by considering the concept of *ṣarf* (currency exchange) as just limited to gold and silver. This last opinion seems to be based on shaky grounds, given the fact that the difference between *fulūs* and paper money is obvious.

Nevertheless, Muslim investors may sometimes be in need of such transactions to manage risk associated with currency fluctuations. Is it possible to modify the existing forward currency market and bring it in line with *sharīʿah* principles? If this is not possible, what is the alternative?

It is indispensable for business managers today to know how the foreign exchange markets work and the ways in which currency risk can be reduced. Changes in the relative value of various currencies can disrupt the planning of firms engaged in the export or import business. Of course, the problem of fluctuating currency values is not so serious if the payment for goods, services, or securities is made promptly. Spot market prices of foreign currencies normally change very little from day to day. However, if payment is to be made weeks or months in the future, there is considerable uncertainty as to what the spot rate will be for any given currency on any given date. When substantial sums of money are involved, the rational investor or commercial trader tries to guarantee the future price at which currency can be purchased. This is the function of the forward exchange market that reduces the risk associated with the future purchase and delivery of foreign currency by agreeing upon a price in advance.³

A forward exchange rate contract is a contract to buy and sell a specified amount of different currencies for physical delivery of either side at some future date, calculated by reference to a contractually agreed strike price.⁴ It is a tool that is used not only by borrowers, but also by traders who typically deal with foreign currency when importing or exporting their products. However, Muslim jurists are almost

³ Peter S. Rose, *Money and Capital Market—The Financial System in the Economy*, Business Publications, 1986, pp. 790–791.

⁴ John Prebber (ed.), *Dimensions in Banking and Foreign Exchange Law*, Wellington, Butterworths, 1992, p. 222.

unanimous in agreeing that it is illegal to exchange currency if it does not involve immediate receipt or taking of possession, as we have mentioned before. Thus, al-Subkī said: “All scholars from whom we have learned are unanimous that any mutual exchange without immediate reciprocal taking of possession is void.” Ibn al-Munzir reported the *ijmāʿ* about it.⁵

Moreover, similar provisions have been adopted by the Egyptian and Sudanese Islamic banks.⁶ In addition, a general stand about such transactions was taken in the second conference of Islamic banks held in Kuwait. It was clearly stated that “It is illegal to exchange gold, silver or currencies unless it is on the spot. Therefore, any exchange on future basis will be a kind of *ribā*.”⁷ Furthermore, the Islamic *fiqh* Academy held a similar position, in its resolution no. 64/1/7 concerning Stock Markets adopted in its seventh session held in Jeddah.

The Accounting and Auditing Organization of Islamic Financial Institutions’s standard no. 1 on Trading in currencies is very explicit:

It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.⁸

It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline.

This prohibitive stand on the illegality of the forward contract in currency exchange is also maintained in the case of deferring one of the countervalues while the second is presented at the spot as in the case of *salam* in commodities. Several *aḥādīth* are explicit on the issue, such as “Exchange of gold for gold, silver for silver, wheat for wheat, oats for oats, dates for dates and salt with salt must be on the spot and in equal quantities, but if the two kinds [of commodities] differ, exchange them as you like, but the exchange must be completed on the

⁵ Ibn al-Munzir, *al-Ijmāʿ*, p. 97.

⁶ Sudin Haron and Bala Shanmugam, *Islamic Banking System Concept and Application*, p. 139.

⁷ See *ʿAbhāth al-Muʿtamar al-Thānī li al-Maṣrif al-Islāmī*, Kuwait, 1983, p. 131.

⁸ Accounting and Auditing Organization for Islamic financial institutions, *Sharīʿa Standards 2004–5*, Standard no. 1 Trading in Currencies, p. 5.

spot and no credit must be involved.⁹ Moreover, there is a consensus among Muslim jurists that such a transaction is not allowed in Islam in the exchange of gold and silver. However, some differences have been reported concerning *fulūs*. These differences are based on the different opinions about the *‘illah* or the rationale of gold and silver as explained above. Thus, some classical scholars are of the opinion that it is legal to exchange *fulūs* in the contract of *salam*.¹⁰ What concerns us more here is the opinion of some modern jurists who seem to have extended the application of this opinion to paper money.¹¹

However, as we have indicated above, the idea of considering *fulūs* commodities and non-*ribawī* items is based on the assumption that the *‘illah* in gold and silver is weight (*wazn*) or *thamaniyyah qāshirah*, which could not be extended to items other than gold and silver. We have already demonstrated the weakness of this argument. Moreover, we may find some excuses for the classical scholars in connection with this issue. First of all, at that time, gold and silver were still the major medium of exchange while today they have been totally replaced by paper money. Second, *fulūs* are used only in the sale and purchase of minor items, which is not the case with modern currencies. In other words, *fulūs* did not possess at that time, according to the proponents of this view, the characteristics of money or *thamaniyyah* in full and were hardly used as a store of value or unit of account and were more in the nature of a commodity. Hence, there was no restriction on their purchase on a deferred basis as is the case with gold and silver. Based on this argument, it is reported from different scholars belonging to the different Islamic schools of law that it is not possible to use *fulūs* as capital in *muḍārabah*,¹² (a contract between a capital owner and an investment manager to share profit) but this is not the case with paper money, which is nowadays the sole medium of exchange.

⁹ Muslim, *Saḥiḥ Muslim with Sharḥ al-Nawawī*, Mu’assasat Manāhil al-‘Irfān, Beirut, 1986, vol. 11, p. 37; see also *Fath al-Bārī Bi Sharḥ Saḥiḥ al-Bukhārī*, Dār Iḥyā’ al-Turāth, vol. 4, p. 304.

¹⁰ See, for instance, Ibn al-Humām, *Fath al-Qadīr*, vol. 5, p. 327.

¹¹ Muhammad Taqī al-‘Usmānī, “Aḥkām ‘Awrāq al-Nuqūd wa al-‘Umulāt” *Majallat Majma’ al-Fiqh al-Islāmī*, no. 3, vol. 3, 1987, pp. 1704–1705; Mohammad Sulaimān al-Ashqar “al-Nuqūd wa taqallub al-Umalah,” *Buhūth Fiqhiyyah fi Qadāyā Iqtisādiyyah*, Dar al-Nafā’is Ammān, 1998, vol. 1, p. 289.

¹² See for instance, Ibn al-Ḥumām, *Fath al-Qadīr*, vol. 6, pp. 168–170; Al-Khirshī, *Sharḥ Mukhtaṣar Khalīl*, vol. 6, p. 205; al-Buhūti, *Kashshāf al-Qinā’*, vol. 3, p. 498, al-Mirdāwī, *al-Inṣāf*, vol. 5, p. 411.

Thus, to allow *salam* on paper money nowadays based on the above argument is a false analogy. The present day currencies have all the features of *thaman* and are meant to be *thaman* only. Therefore, to consider them similar to *fulus* is a false analogy and disregards the basic reality of modern life.

However, the idea of deferring one of the countervalues in foreign currencies has unfortunately attracted some Muslim economists despite its legal weakness. Thus, Mohammed Obaidullah endorsed this position on the assumption that *bay al-ṣarf* means the exchange of gold and silver only. He said, “*bay al-ṣarf* is defined in *fiqh* literature as an exchange involving *thaman ḥaqīqī*,” defined as gold and silver, which served as the principle medium of exchange for almost all major transactions. He went on to say “the tradition mentioned about *ribā*, and the sale and purchase of gold and silver which may be a major source of *ribā*, is described as *bay al-ṣarf* by the Islamic jurists. It should be noted that in *fiqh* literature, *bay al-ṣarf* implies the exchange of gold and silver only, whether these are currently being used as the medium of exchange or not.”

Based on this argument Obaidullah tried to prove that there is no *ribā* in such a transaction from a practical point of view. Thus, he said in his conclusion,

The second types of contracting with deferment of obligations of one of the parties to a future date falls between the two extremes. While *sharī ah* scholars have divergent views about its permissibility, our analysis reveals that there is no possibility of earning *ribā* with this kind of contract. The requirement for settling the obligation of at least one party imposes a natural curb on speculation, though the room for speculation is greater than under the first type of contract. The requirement amounts to the imposition of a hundred percent margin, which, in all probability, would drive the uninformed speculator from the market. This should force the speculator to be a little more sure of his expectations by being better informed. When speculation is based on information it is not only permissible but desirable too. *Bay al-salam* also allows participants to manage risks. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risks.¹³

¹³ Mohammed Obaidullah, “Islamic Contracts for Currency Exchange: Divergent Views and Implications,” *Journal of Objectives Studies*, Institute of Objectives Studies, India, vol. 9, no. 2, July 1997/1416H, pp. 24–46.

However, as we have mentioned above, the divergence of opinion among classical scholars regarding the legality of exchanging *fulūs* on a *salam* basis could not be extended to modern paper money due to the clear differences between the two types of currencies. Obaidullah's analysis may have some basis from a practical point of view, but its legal grounds are very weak and his conclusion is unacceptable. Thus, we may conclude that *salam* or the deferment of one of the countervalues, while the other is delivered at the time of the contract, is illegal and some of the practical advantages advanced in favor of such a transaction cannot overrule this legal position. The present paper currencies have effectively and completely replaced gold and silver as the medium of exchange. Hence, by analogy, exchange involving such currencies should be governed by the same *sharī'ah* rules and injunctions. Therefore, if deferred settlement by either party to the contract is permitted, this would be a clear form of *ribā al-nasī'a'h*.

Obaidullah did not limit this permissibility just to *salam* but extended it to options. Thus, he maintained in his article, "Ethical options in Islamic Finance" that the currency option poses some challenges for scholars and researchers and there are divergent views on the issue of the prohibition of *ribā* in currency exchange. The divergence is due to the process of analogy (*qiyās*) in which the efficient cause (*'illah*) plays an extremely important role. The process of analogy is needed since gold and silver, which performed the function of money in the early days of Islam, have been replaced by paper currencies. It is an efficient cause (*'illah*) that links the object of the analogy with its subject in the exercise of analogical reasoning. The appropriate efficient cause (*'illah*) in the case of currency exchange contracts has been variously defined by the major schools of *fiqh*. Accordingly, some jurists equate currency exchange with *bay' al-ṣarf* in which spot settlement or *qabḍ* by both the parties is insisted upon. Hence, options are automatically ruled out. Others, primarily belonging to the Ḥanafī school, permit deferment of obligation by one party or *bay' al-salam* in currencies and thus admit the possibility of options.¹⁴ This conclusion is also based on the above-mentioned basis and it is unacceptable. However, we will

¹⁴ Mohammed Obaidullah, "Ethical Options In Islamic Finance" *Journal of Objectives Studies*, Institute of Objectives Studies, India, vol. 10, no. 1, January 1998/ 1418-H, p. 79.

discuss the issue of options in currencies when we tackle options trading in general.

Another issue raised by Obaidullah which is also unacceptable is the claim that the different currencies existing nowadays are only *athmān* within the boundaries of the country concerned, unlike gold, which is *thaman* in all places. Therefore, the rules of gold should not be applied to these currencies. Thus, he argued that

A unique feature of *thaman ḥaqīqī* or gold and silver is that the intrinsic worth of the currency is equal to its face value. The question of different geographical boundaries within which a given currency, such as the *dinār* or *dirham*, circulates is completely irrelevant. Gold is gold whether in country A or country B, and any deviation of the exchange rate from unity or deferment of settlement by either party cannot be permitted as it would clearly involve *ribā al-faḍl* and *ribā al-nasīʾah*. However, when the paper currency of country A is exchanged for the paper currency of country B, the case may be entirely different. The price risk (exchange rate risk), if positive would eliminate any possibility of *ribā al-nasīʾah* in the exchange on a deferred basis. However, if the price risk (exchange rate risk) is zero, then such an exchange could be a source of *ribā al-nasīʾah*.¹⁵

Once again Obaidullah based his argument on the Ḥanafī view, although he described it as the opinion of the large majority of scholars. He maintained that the *ribā* prohibition would require a search for efficient cause (*ʿillah*) in the case of exchange involving paper currencies belonging to different countries. Currencies belonging to different countries are clearly distinct entities; these are legal tender within specific geographical boundaries with different purchasing power. Hence, a large majority of scholars perhaps rightly assert that there is no unity of (*jins*). Additionally, these are neither weighable nor measurable. This leads to a direct conclusion that none of the two elements of efficient cause (*ʿillah*) of *ribā* exists in such an exchange. Hence the exchange can take place free from any injunction regarding the rate of exchange and the manner of settlement. The logic underlying this position is not difficult to comprehend. The intrinsic worth of paper currencies belonging to different countries differs as these have different purchasing power. Additionally, the intrinsic value or worth of paper currencies cannot be identified or assessed unlike gold and silver, which can be weighed. Hence, neither

¹⁵ Mohammed Obaidullah, "Islamic Contracts for Currency Exchange: Divergent Views and Implications," p. 35.

the presence of *ribā al-faḍl* (by excess), nor *ribā al-nasīʾah* by deferment can be established.¹⁶

As we have mentioned above, Obaidullah's argument is based on the Ḥanafī' approach in deducing what is the *'illah* in gold and silver and arguing that these modern currencies are neither weighable nor measurable. However, we have already examined the weakness of this approach in deducing the *'illah* and the difficulty faced by the Ḥanafīs themselves in defending it concerning the legality of *salam* in weighable items such as metal. On the other hand, to discern the difference between what is *ribawī* and what is not on the basis of the assumption that the exchange rate risk is positive or it is zero may not be correct all the time. Moreover, even the rate of exchange between gold and silver fluctuated from time to time throughout the Muslim history, but this did not prevent the application of the rules pertaining to *ribā*. Although it is not so volatile as it is in the case of paper money, there is still some fluctuation. Lastly, the claim that these currencies are only legal tender within their geographical boundaries and, therefore, should not be considered like gold and silver in the area of currency exchange, may not be correct in all aspects. Indeed, the currency of country A may not be accepted as a medium of exchange in country B, but it is still recognized as a store of value and can be exchanged with the currency of the first country without any reluctance, as long as it is still the legal tender in its country of origin. For instance, the Saudi riyal may not be accepted as a medium of exchange within Malaysia, but it is recognized as a store of value and not just ordinary paper and can be exchanged with the Malaysian ringgit at any time and any place. It is similar to the case when one country is using gold as the medium of exchange while the other is using silver. Both are regarded as stores of value and the mediums of exchange in their respective countries, and one medium of exchange may not be accepted as legal tender in the other country, but they could not be exchanged unless it is hand-to-hand. From the above, we could say that to exchange different currencies on the *salam* basis is illegal and there is no difference between the deferment of one of the countervalues or both of them due to the clear *ḥadīth* stated before.

¹⁶ Ibid., pp. 28–29.

However, recognizing the benefits of forward currencies trading in the modern economic system¹⁷ and being aware of the general agreement that a deferred contractual obligation in foreign currencies is illegal in Islamic law, Muslim scholars are striving to find the suitable Islamic alternative, which can secure some of the benefits of the forward currency exchange without contravening Islamic rules. Thus, the idea of mutual promise in currency exchange has been developed.

Mutual Non-Binding Promise in Currency Exchange

The need for mutual non-binding promise for currency exchange in modern transactions is evident in the import and export sectors due to unpredictable currency and exchange rate fluctuations. Thus, for instance, a Malaysian exporter opens a credit in favor of an Egyptian importer for the purchase of, say, palm oil. The rate of exchange of the ringgit to that of the Egyptian pound may differ from the date of the opening of credit until the receipt of the value of the said credit. The Egyptian importer wishes to avoid the rise or fall of the exchange rate while this promise will be executed on a future date agreed upon between the parties after a real contract. Therefore, he would prefer to carry out a promise of exchange of currencies by executing a promise

¹⁷ It is worth mentioning that some scholars have totally excluded any benefit for forward currency trading. Thus Sāmi Hamoud held that "It is well known fact that in practice dealing in exchange on the basis of the forward rate represents neither the need of commerce nor the ordinary commercial activity, but is more or less a speculation in the rate of currencies and of interest in the main international centers. For this reason the local banks of many countries neither involve themselves nor deal in this risky kind of exchange, which is rather an act of gambling." This statement may have a kind of objectivity with regard to those entering the forward currency market as speculators, but it would be totally unfounded in the case of genuine traders trying to hedge themselves against any currency fluctuation in the future. Moreover, the reasons for which he is defending the concept of mutual promise in foreign exchange trading are the same reasons for forward currency trading as practiced in the conventional system of finance. It may be somewhat acceptable to say the harm in such a transaction is greater than the benefit if it is used for speculative purposes. Therefore, it should not be allowed in Islamic law. It could also be argued that it is against the principle of currency exchange in Islam according to the majority opinion. For instance, in principle a *ṣarf* transaction should be hand to hand and therefore, it should be prohibited. However, to pass a general judgment that there is no benefit in such a transaction is far from reality. Moreover, some commentators followed this opinion without any effort to investigate the issue or to analyze it. See, for instance, Abd Allāh Abū Umair, *al-Tarshīd al-Sharī lil Bunūk al-Islamiyyah*, International Association of Islamic Banks, p. 280.

for the purchase of the equivalent amount of goods at the rate of exchange prevailing on the date of opening the credit. Thus, this is a mutual promise of exchanging currencies at the spot rate. It does not involve delivery on the part of either party: it just involves a promise to purchase, on a future date, at a rate fixed in advance.

The majority of Muslim scholars consider any promise to conclude a foreign exchange transaction followed by a real contract to confirm it later as an illegal transaction.¹⁸ Thus, for instance, Ibn Juzai cited three opinions on the matter: the abhorrence (*karāha*) of the promise of exchange, which is also the most renowned opinion; permissibility (*Ibāḥā*); and banning (*ḥurma*).¹⁹ Ibn Rushd (the grandfather) maintained that in the exchange of gold for silver, as well as in the sale of gold for gold and silver for silver, mutual promise, option, guarantee and assignment (transfer) are not permissible; only the immediate delivery is possible. Also, al-Khirshī considered such kind of exchange as void; he cited an example where a man tells another: “Let us go to the market and take your *darāhims* with you; if they are good I will take them from you so many for so many *dirhams*.” Then he quoted the view of Ibn Shass to the effect that if such a case is permissible in marriage during the ‘*iddah* (the waiting period for a woman who has been divorced before marrying another person) it would be even more appropriate in this case.²⁰

Some modern Muslim scholars have also opposed the idea of mutual non-binding promise in dealings involving foreign currency. Aḥmad Muhy al-Dīn argues that such a promise is, in reality, a contractual obligation, since the agreement must be executed at its maturity date. Moreover, such a promise is not always concluded with good Muslims since commercial deals could also be concluded with non-Muslims and some morally corrupt persons who may not worry about defaulting on their obligations as there are no legal consequences for such a default. Besides, such a mutual promise contradicts the principle of immediate or hand-to-hand delivery stipulated in the *ḥadīth* which is unanimously agreed upon as a condition in *ṣarf* or currency trading. In addition,

¹⁸ See for instance Mohammad Qadri Bāshā, *Murshid al-Ḥairān*, p. 63. Ulesh, Sharḥ, *Mīnah al-Jalīl’alā Mukhtaṣar khalīl*, vol. 2, p. 510. Ibn Rusd, *al-Muqaddimāt*, Dār Sādir, Beirut, vol. 2, pp. 507–9.

¹⁹ Ibn Juzai, *al-Qawānīn al-Fiḥiyyah al-Shar’iyyah*, Beirut, Maktabat ‘Ālam al-Fikr, 1975, p. 263.

²⁰ Al-Khirshī, *Sharḥ Mukhtaṣar khalīl*, vol. 5, p. 36.

if we consider this transaction as a mutual promise while in fact it is honored like a real contract, it would no longer be a promise because “What is honored by custom is like what is stipulated as a condition.” And “Consideration in contracts is to be given to the meaning and not the form.” Furthermore, the objective of such a deal is to fix the exchange rate at an agreed rate until the time of delivery and this could not be done unless there is a contract, as is the case in the conventional practice. Therefore, to apply the idea of mutual promise in *ṣarf* as cited from al- Shāf‘ī and Ibn Ḥazm is an invalid analogy.²¹

However, the permissibility of the mutual promise in *ṣarf* or currency exchange is reported from al- Shāf‘ī, Ibn Ḥazm al-zāhirī, and Ibn Nāfi‘ from the Mālikī school. They regarded it as a legal transaction without any reservation, while some other Mālikī scholars have divergent opinions on the issue. Thus, al- Shāf‘ī said: “If two persons make a promise to each other to exchange foreign currency in the future, there is no problem.”²²

The main argument is that a promise is not a contract and there is no textual evidence that disallows such a transaction. Thus, Ibn Ḥazm stressed that “to make a promise to someone to buy or to sell gold for gold, silver for silver, and the four other items cited in the *ḥadīth*, is legal whether the parties confirm this promise by a contract later or not. This is because exchanging promises is not a contract and there is nothing which prohibits it.”²³ Ibn Nāfi‘, a Mālikī scholar, has a similar opinion.²⁴ Ibn al-Qāsim, another Mālikī scholar, pointed out that such a promise should be discouraged, but if a contract has been concluded later on the basis of this promise, it would be legal and should not be dissolved.²⁵

The same line of argument among the classical scholars is manifested in the writing of modern scholars. Thus, considering the complexity of modern financial transactions, the need for a better planning in international trade, and bearing in mind the general agreement among Muslim jurists that a forward contract to exchange different foreign currencies is illegal in Islam, some modern Muslim jurists have suggested

²¹ Aḥmad Muḥyi al-Dīn, *‘Amal Sharikāt al-Istithmār al-Islāmiyyah Fi al-‘Aswāq al-‘Ālamīyyah*, pp. 340–344.

²² al-Shāf‘ī, *al-‘Umm*, vol. 3, p. 32.

²³ Ibn Ḥazm, *al-Muḥallā*, vol. 2, p. 513.

²⁴ Al-Ḥattāb, *Mawāhib al-Jalil li-Sharḥ Mukhtaṣar khalil*, vol. 4, p. 513.

²⁵ Ulesh, *Sharḥ Minaḥ al-Jalil ‘alā Mukhtaṣar khalil*, vol. 2, p. 510.

the adoption of the concept of promise to exchange different currencies followed by a real contract to confirm it as a solution to the modern problem of currency fluctuation.

Thus, the *sharī'ah* boards of several Islamic financial institutions have opted for the approval of this kind of transaction. For instance, in the first al-Barakah seminar a question was addressed as to the legal position of making a promise to buy different currencies at the rate of the day of agreement (the day of mutual promise) on the condition that the mutual delivery of the exchange will occur later. This exchange in the future will be hand to hand, considering that such a promise could be binding or not. The answer was,—“If such a mutual promise is binding on both parties, it falls under the general prohibition of selling credit for credit, and it is not permissible. However, if it is not binding upon the two parties, then it is permissible.” (First Albaraka Seminar, Fatwā no. 13).

A similar question was again raised in the sixth al-Baraka seminar as to the position of Islamic law on the issue of mutual promise concerning currency exchange. The answer was

The rule in this issue is to confirm what is stated in the resolutions adopted by the Second Conference of Islamic Banks held in Kuwait, March 1983. The arrangement for the sale of currencies with deferred payment is permissible provided the promise is not binding (This is the opinion of the majority). If the arrangement is binding, it is not permissible. (Sixth al-Baraka Seminar, Fatwā no. 23).²⁶

The question was addressed to the *sharī'ah* board of the Kuwait Finance House, as to what is the *sharī'ah* position on the possibility of making a mutual promise to buy foreign currencies with the price determined today and the mutual delivery will take place later. The board's answer was. “This kind of transaction is a mutual promise to buy, and if the transaction is executed as it is formulated in the question, then there is no legal problem. However, if the mutual promise is related to anything that makes it binding, then it will be a kind of *bay' al-kālī' bi al-kālī'*, which is prohibited.”²⁷

²⁶ Dallh Albaraka, *Fatwa: Sharī'ah Ruling on Economics*, Dallah Albaraka Research and Development Department, Jeddah, Saudi Arabia, 1414/1994, pp. 71–72.

²⁷ Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Sharīyyah fī al-Masā'il al-Iqtisādiyyah*, Kuwait, 1986, vol. 1, p. 50.

The problem was addressed to the *sharī'ah* consultant of the Jordanian Islamic bank in connection to the problem of currency fluctuation facing those who want to perform *hajj*. The question was, "To facilitate the issue of pilgrimage for those who are willing to visit the holy sites, the Ministry of Awqāf would like to make an agreement (mutual promise) with the Jordanian Islamic bank to purchase Saudi riyal at the price fixed at the exchange rate of the day of the mutual promise, while the mutual delivery will take place six months later. The Islamic bank will deliver to the Ministry a cheque bearing the amount needed in Saudi Riyal, and the Ministry for its part will deliver the amount in Jordanian dinār." Is it legal to make such a deal?

In his reply to this question the *sharī'ah* advisor said

The mutual promise to exchange different currencies with the exchange rate fixed on the day of the mutual promise and the mutual delivery to take place later without any regard to the exchange rate of the day of delivery is legal. This could be accommodated in what is reported in *Nayl al-Awtār* where the Ḥanafīs and Shāf'ī's are of the opinion that it is possible to exchange different currencies at the exchange rate of the day, more or less. This approach may contravene what Ibn 'Umar reported to the effect that the legality of such a transaction is limited only to the exchange rate of the day. However, it seems that the two Imams (Shāf'ī and Abū Ḥanifā) have based their opinions on the general *ḥadīth* in which the prophet said, "If these items [the six different items mentioned in the *ḥadīth of ribā*] are different, then, you can buy and sell if it is hand to hand. Therefore, I consider such a deal, based on the Shāf'ī and Ḥanafī opinion, as legal."²⁸

However, a close look at what is reported in *Nayl al-Awtār* shows that the case to which the *sharī'ah* advisor is referring is about someone collecting his debt in a specific currency, which he gave as credit but would like to receive it now in another currency. In such a case it is possible to get it back in another currency whether it is more or less than what is in the liability of the debtor, because since it is an exchange of different currencies, there is no need for equality. But it should be hand to hand. Therefore, it seems that the *sharī'ah* consultant formed his opinion by making an analogy with this case since what is reported in *Nayl al-Awtār* is about collecting a debt and not about currency exchange.

²⁸ Jordan Islamic Bank, *al-Fatāwā al-Shar'iyyah*, vol. 2, p. 11.

The advocates of this opinion argued that there is nothing that could prohibit such a transaction, since there is no *ribā*, *gharar*, or *jahālah*. On the contrary, the transaction serves a real public interest.

Sāmi Ḥamoud, one of the first advocates of this alternative, argued that if we look into the facts of the case and take into consideration the service which the importer receives from the transaction (in the case of the mutual promise to buy) and the service which the exporter receives (in case of the mutual promise to sell), we find that the reassurance made to the importer in regard to the price which he will pay, and to the exporter for the price he shall receive, is a matter which has its importance. Where the bank has to perform extensive transactions it will be able to balance the mutual promise of sale and purchase transaction *per se* where no real dealings of imports and export are involved.²⁹

Farḥān al-Abbār argued that the concept of mutual promise is outside the boundaries of the texts prohibiting the exchange of currencies unless they are exchanged on the spot. The objective of these texts is to prohibit the deferment of one of the countervalues while the second is present. This difference of time is the cause of *ribā*. This is totally different from the mutual promise where both countervalues are exchanged later at the same time and on the spot. What is agreed upon through the mutual promise is just the exchange rate³⁰ and not the formation of a contract of currency exchange.

ʿAbbās al-Bāz argued that the objection of those who reject the mutual promise to sell foreign currencies will be correct if the parties in the contract consider it a binding obligation, which may fall within the ambit of *bayʿ al-kāliʿ bi al-kāliʿ*. However, what the advocates of this opinion propagate is just a promise and a promise is not a contract. Furthermore, to consider the fulfillment of the promise as obligatory or *wājib* if the second party enters into another deal based on this promise will not transform the promise into a contract. Therefore, any request for damages if one party is affected by the default of the other will be based on the failure to fulfill his promise and not the failure to fulfill his contract. In practice, the different parties would strive to fulfill their commitment not because they consider it a contract but just to safeguard their reputations and to win the confidence of other

²⁹ Sāmi Ḥassan Ḥamoud, *Islamic Banking: The Adaptation of Banking Practices to Conform with Islamic Law*, Arabian Information, London, 1985, p. 180.

³⁰ Farḥān al-ʿAbbār, *Qadā yā Muʿāshirah fi al-Nuqūd*, p. 322.

market players in a competitive market. In addition, if we look to the *ratio* behind the prohibition of such kinds of transaction, it is about preventing people from using money as a commodity for trade. In the case before us, the objective of the parties is not to trade in currency but just to manage any risk arising from currency fluctuations and to safeguard the mutual interest of the parties. Finally, it is evident from practice that such a deal has not been the cause of financial crises and none of the parties will use the transaction to monopolize the currency demanded.³¹ El-Gārī had a similar opinion if the promise was not binding³² and Rafīq al-Miṣrī also shared the same opinion if the mutual promise was not obligatory. In the same context, it should be noted he considers the prohibition of deferment in currencies on the same basis of sale of debt for debt and not as a case involving *ribā*.³³ Some other scholars also endorsed the idea.³⁴

The AAOIFI's Shariah standard on currencies trading states the following: "A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even if for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible even if the promise is binding."

However, despite the arguments advanced by the proponents of the idea of mutual promise, it has been criticised by other scholars, some of whom we have mentioned above. Mindful of these criticisms, some scholars have come up with new suggestions to resolve the problem.

Mutual Loan and Currency Risk Management

Some have advanced the idea of mutual loans. It should be noted once again that Muslim scholars are only concerned with the problem facing genuine traders and how they could manage their investment risks without compromising *sharī'ah* rules. It is with this vision that the idea

³¹ See 'Abbās Aḥmad al-Bāz, *Aḥkām Sharf al-Nuqūd wa al-'Uumlāt fi al-Fiqh al-Islāmī*, Ammān, Dār al-Nafā'is, 1999, pp. 130–131.

³² Mohamed 'Ali El-Gārī, "al-Aswāq al-Māliyyah", *Majallat Majma' al-Fiqh al-Islāmī*, p. 1626.

³³ Rafīq al-Maṣrī, *al-Jāmi' fi Aḥkām al-Ribā*, p. 148.

³⁴ 'Abd Allāh 'Abd Al-Rahīm al-'Abādī, *Mawqif al-Sharī'ah min al-Maṣārif al-Islāmiyyah*, pp. 318–319; Mustaphā 'Abd Allāh al-Hamsharī, al-Maktab al-Islāmī, Beirut, 1986, pp. 378–9, and Jihād Abū 'Umair, *Al-Tarshīd al-Sharī' lil Bunūk al-Islāmiyyah*, International Association of Islamic Banks, p. 204.

of mutual loan or “*al-murābahah al-islāmiyyah*” or the Islamic swap, as it was described by Jamāl al-Dīn ‘Aṭiyyah, has been advanced. In this transaction the Islamic bank and the genuine investor will exchange an equivalent amount of money in different currencies for a specific period as a mutual loan (*qardḥ ḥasan*). During this period each party has the right to use the amount of money he received in his respective investment and will refund his original money on the agreed date.

To illustrate the situation we may take the following example. A particular investor has, for instance, the amount of US \$1 million that he wishes to invest in Germany. However, he is afraid of the fluctuation of the German mark during the period of the investment. Thus, to manage this risk he may enter into an agreement of mutual loan with the Islamic bank. He gives his US \$1 million to the Islamic bank as a *qardḥ ḥasan* and he will receive the equivalent of this amount in German marks from the Islamic bank as a *qardḥ ḥasan* as well. Each one has the right to invest what he has received during this period and at the agreed date each of them will refund his original amount of money or his *qardḥ ḥasan*. Thus, this investor will have hedged himself against any fluctuation of the German mark during this period at least for his original capital.

However, it should be noted that the profit that may be generated from this investment falls outside this approach of hedging.³⁵ On the other hand, the new formula will be useful only if both parties have already at hand the required amount of money before entering the mutual exchange of *qardḥ ḥasan*. Moreover, the Islamic banks may not be willing to cooperate; this is as it should be with these investors, since there is no real benefit for the Islamic bank in such a deal. Furthermore, it may face the risk of default from these customers.

Currency Basket and Risk Management

A third solution regarding the problem based on the concept of currency basket has been advanced by Saud Mohammad. He argued that

³⁵ Jamāl al-Dīn ‘Aṭiyyah, *al-Bunūk al-Islāmiyyah Bainā al-Hurriyyah wa al-Tanzīm; al-Taqlīd wa al-Ijtihād; wa al-Nazariyyah wa al-Taṭbīq*, kitāb al-Ummah, Qaṭar, Ri’āsat al-Mahākīm al-Shar‘iyyah wa al-Sh‘ūn al-Dīniyyah, Qaṭar, 1988, p. 163. Also see Abū al-Majd Ḥarak, *al-Bunūk al-Islāmiyyah ma lahā wa ma ‘Alayhā*, Dār al-Ṣaḥwah, Cairo, n.d., p. 87.

an importer who faces the risk of currency fluctuation may make an arrangement with the owner of the commodities to be imported that the settlement of the price will be made in several different hard currencies. It could be, for instance, the American dollar, the German mark, the Swiss franc, and the Japanese yen. Thus, any depreciation in any one of these currencies will be balanced by the appreciation of others and it is unlikely that the package of currencies selected will depreciate all at once. Thus this investor may be able to manage the risk of currency fluctuation to some extent. However, it should be noted that this formula could be of some help only for importers. Regarding exporters, it is argued that those involved in export oriented trade should invest in countries which do not place a lot of conditions on exports. Consequently, at any period where there is currency depreciation in these countries, this investor will be able to increase his exports since his products will be more competitive on the international market.³⁶

Managing Price Fluctuation through Deposit

Another solution proposed for an importer to protect himself against currency fluctuation is that he should buy the amount of currency needed for the settlement of his obligation and deposit it in the Islamic bank and withdraw it when the time to settle his obligation comes.³⁷ It is clear that this solution will be useful only if the investor concerned has the money at hand at the beginning. Moreover, through this mechanism he will be prevented from investing this money in another planned project.

Cooperative Funds and Currency Risk Management

A final solution to this real problem is that the different parties involved in the import-export trade may establish a cooperative fund in which the different parties would deposit a certain amount. An Islamic bank,

³⁶ Saud Mohammad al-Rubaia', *Tahwīl al-Maṣrif al-Ribawī ilā Maṣrif Islāmī Wa Muqta-dayātuḥu*, Markaz al-Makhtūtāt wa al-Turāth wa al-Wathā'iq, n.d., pp. 299–300.

³⁷ Ibid., p. 298. Also see 'Abbās Aḥmad al-Bāz, *Aḥkām Ṣarf al-Nuqūd wa al-Umlāt fi al-fiqh al-Islāmī*, 'Ammān, Dār al-Nafā'is, 1999, p. 131 and Jihād Abd Allāh Ḥussein, *al-Tarshīd al-Shar'ī lil Bunūk al-Islāmiyyah*, Matbū'āt al-Ittiḥād al-Dawlī lil Bunūk al-Islāmiyyah, p. 204.

for instance, could manage the fund on their behalf. The parties would share the profits, if any, and at the same time they would be able to face any risks associated with currency fluctuation.³⁸

Thus, it seems that all these solutions have some advantages but also some limitations. Nevertheless, one could say that the idea of mutual promise may not be the perfect solution to the problem and it may not be without criticism. However, it could be considered as a suitable temporary solution to the problem until a perfect one is discovered.

Our choice of this method would not be complete, however, unless we state the *sharī'ah* position regarding such a promise. Muslim scholars agreed that if the promise is related to permissible matter, then, the one who makes a promise should fulfill it. However, they disagree as to whether such a fulfillment is obligatory or just recommended. For the majority it is just recommended to keep a promise. Therefore, if someone fails to keep his promise, he will just miss the reward he may get in the Hereafter.³⁹ However, Ibn Shubruma regarded the fulfillment of a promise as compulsory and if the one who makes the promise fails to do so, he will be forced by the court to fulfill his obligation. This opinion has also been attributed to the companion Samura Ibn Jundub, 'Umar Ibn 'Abdul Azīz, the fifth rightly guided caliph, al-Ḥassan al-Baṣrī, Ishāq Ibn Rūhawaih, Sa'īd Ibn Omar Ibn al-Aswa', al-Bukhārī, and Ibn Qayyim. After attributing this opinion to this large number of scholars, al-Qaraḍāwī maintained that it is clear that to attribute this opinion to just Ibn Shubruma and some Mālikīs, as it is alleged by some commentators, is unfounded. On the other hand, refuting the claim that what is reported about the obligation to fulfill a promise is just limited to the promise related to charity and *ma'rūf*, al-Qaraḍāwī said:

This is an unacceptable distinction. The legal evidence in the issue is general and there is no evidence to restrict it to one area or another. However, if we have to make a distinction between what is charitable and the one involving financial transactions, it seems that the opposite of what is claimed is right: it is logical to consider such a promise binding in the area of financial transactions rather than that of a charity. This is so because the financial harm which will be inflicted on the one entering the deal as a commercial partner, who relies on this promise, will be much greater than that with the one who is depending on charity. Therefore,

³⁸ Qhassān Burhān al-Dīnqal'aji, *Taqwīm Adā' al-Nashāt al-Maṣrifī al-Islāmī*, p. 107.

³⁹ See, for instance, al-Nawawī, *al-Azkār al-Muntakhaba min Kalām Sayyed al-Abrār*, p. 282; Ibn Ḥazm, *al-Muḥallā, bi al-Athār*, vol. 8, p. 513.

the need to consider the promise as binding, especially if the party who receives the promise is involved in a financial obligation, should not be a point of disagreement.⁴⁰

The Mālikīs are the most explicit in their support for the legal status of a promise status and discussed it in detail. Thus, according to Mohammad Ulesh, “There is no disagreement that the fulfillment of a promise is recommended. However, there is disagreement concerning its obligation. Is it obligatory to fulfill any promise or is it just recommended?”⁴¹ The widely accepted opinion is that if the other party, while relying on this promise, enters into some financial obligation based on that promise, then the one who makes the promise should be obliged by the court to fulfill it as his obligation.⁴² Thus, the final resolution of the Islamic *Fiqh* Academy in its fifth session, Decision no. 2, held in Kuwait, stated that a promise is binding from the religious point of view except when there is an acceptable excuse. It is also binding in the court of justice if the promise is dependent on certain reasons and the one promised has incurred some costs as a result of the promise.

On the other hand, despite the fact that the modern spot transaction in foreign exchange mentions that delivery will take place immediately, in practice this is not the case in most instances, specially when the different banks are located in different countries. Generally, a spot foreign exchange is defined as an agreement to deliver a specified amount of foreign currency at an agreed price, usually within one or two business days and sometimes on the same day.⁴³ However, this delay of two days does not prevent a western scholar from considering it as a contract of immediate delivery. However, in Islamic law such a delay may pose some legal problems and could be considered as a forward contract rather than a spot one.

Saud Mohammad argued that considering such a transaction as a spot transaction is misleading from the Islamic point of view, since

⁴⁰ Yousuf al-Qaradāwī, “al-Wafā’ bi al-Wa’d,” *Majallat Majma’ al-fiqh al-Islāmī*, vol. 1 no 6., pp. 849–856. For similar opinion and investigation see also ‘Abd- Allāh Ibn Manī’, “al-Wafā’ bi al-Wa’d wa ḥukm al-Ilzām bihi”; Harūn Khalīfa, “al-Wafā’ bi al-wa’d fi al-Fiqh al-Islāmī”; Ibrahim Fāḍil al-Dabu, “al-Wafā’ bi al-wa’d” in the same journal.

⁴¹ Mohammad ‘Ulesh, *Fatḥ al-‘Alī al-Mālik fi al-fatwā ‘alā Madhhab al-Imām Mālik*, vol. 1, pp. 254–258.

⁴² See, for instance, Shihab al-Dīn al-Qarāfi, *al-Furūq*, Dār al-Ma‘ārifah, Beirut, vol. 4, pp. 21–25.

⁴³ Peter S. Rose, *Money and Capital Market—The Financial System in the Economy*, Business Publications, 1986, p. 791.

delivery will take place after two working days. The exchange of offer and acceptance by telex or any other electronic media could not be considered as delivery because a real delivery will take place only when the other party has withdrawn the exchanged money from his account or he is in position to do so. Therefore, the modern spot foreign currency exchange could not be considered as a spot currency transaction. It is, then, an illegal transaction according to the Qur'ān and Sunnah.⁴⁴ However, Saud went on to suggest that the delay of two days in such a transaction could be minimized by the opening of a mutual current account with all the banks that the Islamic bank deals with. Thus, after a spot transaction, both banks will be able to transfer immediately the exchanged amount to the account of its counterpart.

Commenting on such a situation, Akram Khān wrote

The contemporary practice of allowing a two-day lag cannot be accepted in the Islamic framework. One alternative could be that the exchange is effected simultaneously by involving correspondent banks or agents at the same situation. For example, suppose a bank in Ottawa wants to exchange US dollars for Australian dollars, and the Australian bank is based in Canberra. The Canberra bank may authorize a corresponding bank in Ottawa to carry out the above transaction on its behalf simultaneously or the Canadian bank may authorize a corresponding bank in Canberra to execute the said transaction on its behalf. In brief, some mechanism will have to be devised to execute the transaction simultaneously.⁴⁵

However, in this particular case since the concept of account record or *al-qabḍ al-ḥisābi*, which is recognized by many contemporary Muslims as a legal one the issue could be accommodated under it. Moreover, such a transaction has become a necessity and we should not stick to the literal meaning of the *ḥadīth*. Furthermore, the whole concept of *qabḍ* is based on custom and, therefore, whatever means judged by the experts to be so should be accepted.

More importantly, the Islamic Fiqh Academy in its resolution 55/4/6, March 1990, regarding “*Al-qabḍ* or Taking of Possession, its New Forms, and Their Rules,” maintained that:

⁴⁴ Saud Mohammad al-Rubaya, *Tahwīl al-Maṣrif al-Ribawī ilā Maṣrif Islāmi Wa Muqṭadayātuḥu*, Markaz al-Makhtūtāt wa al-Turāth wa al-Wathā'iq, vol. 1, p. 278.

⁴⁵ Muhammad Akram Khān, “Commodity Exchange and Stock Exchange in Islamic Economy,” p. 103.

1. Taking of possession of properties could be through handing over, scaling, measuring, or by transferring the purchased item to the buyer's possession. It could also be *ḥukmī* (constructive) by enabling the buyer to do any action he wants with the property bought even if there is no physical taking of possession. Furthermore, the way of taking of possession could differ according to the subject matter of the contract and the change of custom on what could be considered as taking of possession.
2. Among the forms of *al-qabḍ al-ḥukmī* (constructive) recognized by *sharī'ah* as well as by custom is *al-qabḍ al-ḥisābī* or account record in the account of a client in the following situations:
 - By depositing the specific amount of money in the client's account whether directly or through money transfer.
 - The client concluding a spot currency exchange with the bank and that to be deposited in his account.
 - The bank deducting a specific amount of money from the client's account, under his direction, to place in another account in the same bank or another bank, for himself or for another person, and the Islamic financial institutions observing the rules of *ṣarf*.

The delay in recording for a period, which disallows the beneficiary from really taking possession, according to market practice is not considered a problem. However, the beneficiary should not make use of the money during this period until he receives the confirmation of real delivery.⁴⁶ Similarly, *al-Majma' al-Fiqhī al-Islāmī* in Makkah in its resolution in the eleventh session, 1989, considered account record as a *qabḍ ḥukmī* in money exchange and transfer.⁴⁷

In conclusion, it may be said that although some scholars, if not the majority, are still reluctant to admit the legality of the forward contract in the commodity market, the general principles of Islamic law do not reject it. Yet, some scholars, such as Nazīh Ḥammād, approve it but under the principle of *ḍarūrah* or necessity. Perhaps it was on this basis that Aḥmad Ḥassan tried to restrict the use of this contract in his book *al-Awrāq al-Māliyyah* just for the use of exports and imports, and maintained that it could not be extended to the stock market, for

⁴⁶ See *Majallat Majma' al-Fiqh al-Islāmī*, no. 6, vol. 1, 1990, pp. 771–772.

⁴⁷ *Ibid.*, pp. 734–735.

instance. It should be noted that he strongly defended the legality of this contract without any restrictions in his book *'Amal al-Sharikāt al-Islāmiyyah*. However, as we have demonstrated above, the admission of forward contracts in commodity trading in particular is not contrary to any principle of Islamic commercial law, but is based on the ordinary norms of the *sharī'ah*. It is not, then, an exceptional case of necessity or *ḍarurah*.

However, one may ask why the futures contracts are needed if forward contracts are sufficient for risk management purposes. It should be noted that despite the fact that the forward contract is a useful tool for risk management, it has its own shortcomings and is sometimes associated with practical problems that could only be overcome through the futures contracts. The three main problems that are associated with the forward contract are as follows:

The first problem may be classified as the problem of double coincidence. Here a party to a forward contract would have to find a counterpart who not only has the opposite needs with the underlying assets but also with regard to time and quantity. The counterpart must demand the product in the right quantity, at the right time. Thus, a number of factors have to coincide before a forward contract could be made. The second problem with the forward contract often lies with the way the forward price is arrived at. Typically, the forward price is arrived at through negotiation, depending on the bargaining position of the parties. Therefore, it is possible that a forward price is forced upon the other party. This may be due to the urgency of one party (e.g., perishable goods) or, more commonly, due to asymmetric information. The third and probably the most important problem with forward contracts is the counterpart risk. Counterpart risk refers to the default risk of the counterparts in the contract. Though a forward contract is a legally binding arrangement, legal recourse is slow, time-consuming, and costly. Default in forward contracts arises not so much from dishonest counterparts but from increased incentive to default as a result of subsequent price movements. When the spot price rises substantially above the forward price, the short position (seller) has the incentive to default. The long position would have the same incentive to default if the opposite happens and the spot price falls sharply.

As these shortcomings of the forward contract became apparent over time, a new instrument that would provide the risk management benefits of forward contracts while simultaneously overcoming their problems was needed. The resulting innovation was the futures contract. A futures contract is essentially a standardized forward contract. It is standardized with respect to contract size, maturity, product quality, place of delivery, etc. With standardization, it is possible to trade them on an exchange,

which in turn increases liquidity and, therefore, reduces transaction costs. In addition, since all buyers and sellers transact through the exchange, the problem of double coincidence is easily overcome. One would transact in the futures contract maturity as many contracts as needed to fit the underlying asset size.

With the exchange trading, the second problem with forward contracts, that is of being possibly locked into an unfair price, would not exist. This is because each party is a price-taker with the future price being that which prevails in the market at the time of the contract initiation. As exchange quoted prices are market-clearing prices arrived at by the interaction of many buyers and sellers, they would by definition be “fair” prices.

The problem of counterparty risk is overcome in futures contracts by means of the innovation principle. The exchange, being the intermediary, guarantees each trade by being the buyer to each seller and the seller to each buyer. What this means is that each party transfers the counterparty risk of forward contract onto the exchange in the case of futures contracts. This transfer of risk to the exchange by the parties in the futures contract has to be managed by the exchange, which now bears the risk. The exchange minimizes the default risk by means of the margining process and by daily marking to the market. The basic idea behind the margining and marking to market process is to reduce the incentive to default by requiring initial deposits (initial margins) and recognizing losses as they accrue (margin call). This margining and marking to market process has been refined and fine-tuned over the years by futures exchanges to such an extent that incidences of systematic default have been reduced to negligible rates.⁴⁸

Seyed ‘Abd al-Jabbār, the chief executive of the Kuala Lumpur Commodity Exchange, pointed out one of the shortcomings of the forward market in his comments to Akram Khān’s study and said, “The author is right in saying that, without a futures market, a trader can still hedge in the forward market, e.g., the Refined Bleached Deodorised (RBD) Palm Oil string contract. But a default could occur in the string and if that happened there will be a lot of dissatisfaction and disputes. In a futures market there is the guarantee mechanism, which will assure

⁴⁸ See Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,” p. 5.

parties to a contract guarantee of financial performance in the case of defaults. The clearinghouse gives this guarantee.”⁴⁹

In the next part of the study we will address the issues related to futures contracts in commodities markets, such as their concept and scope from an Islamic point of view, the issue of sale prior to taking possession, the issue of just looking for price differentials, speculation and selling with margins. In addition, the issue of sale of debt for debt or *bay' al-dayn bi al-dayn* and its effects in the development of an Islamic futures market will be addressed. Moreover, the study will expound on futures markets' regulation, the market offenses and how the Futures Industry Act in Malaysia, in particular, deals with them.

Still, the issue of looking for price differentials remains an important issue not only for the development of a viable Islamic futures market but also for the development of an Islamic financial system in general. Is looking for price differential a kind of gambling or speculation? Is it possible to use hedging in Islamic finance? How could we differentiate between speculation and hedging? Is it possible to make such a distinction by looking to the behavior of the market participants? What is the role of brokers in these markets? Is it in line with Islamic principles? What is the role of the clearinghouse? Is it necessary for a clearinghouse in an Islamic market to be different from that in a conventional market? These issues will be investigated next.

Concerning the possibility of a futures market in currencies from an Islamic perspective, as we have seen in this part, even the conventional forward contract in currencies is illegal in Islamic law, and because of that Muslim scholars have resorted to other alternatives. Therefore, to think of a futures market is out of context. Moreover, the larger part of the currency market transactions at present is done under the forward market followed by the spot market and lastly the futures market.⁵⁰ Therefore, any Islamic alternative in the currencies market should focus on the forward market. Some alternatives have already been suggested, as we have explained above, but more innovations are still needed.

⁴⁹ Seyed 'Abd al-Jabbār Shahabudin, “Comment on Akram Khān's 'Commodity Exchange And Stock Exchange in Islamic Economy',” *Journal of Islamic Economics*, International Islamic University, Malaysia, vol. 1, no. 2, July 1988, p. 72.

⁵⁰ The forward contract dominates the currency market with seventh-three percent of the total market. It is followed by the swap market with eighteen percent, the options market at 3.5% and the futures market at one percent. See S. Sagha Balvinder, “Financial Derivatives: Applications and policy Issues”, *Business Economics*, The Journal of the National Association of Business Economists, vol. xxx, Jan 1995, p. 48.

THE FUTURES MARKET

CHAPTER FIVE

CONCEPT, SCOPE OF FUTURES CONTRACTS AND SPECULATION

Concept of Futures Contracts

The nature of the futures markets was described by J. Lockhart in *Sydney Futures Exchange Ltd v. Australian Stock Exchange Ltd* (1995) 13 ACLC 369 as follows:

A futures market is a market in which people buy and sell things for future delivery. A futures contract generally involves an agreement to buy and sell a specified quantity of something at a specified future date. The price is variable, determined competitively by 'open outcry' on the trading floor or through a computer-based marketplace. Futures markets perform the economic function of managing the price risk associated with holding the underlying commodity or having a future requirement to hold it. The futures market is a risk transfer mechanism whereby those exposed to risks shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator. By contrast securities markets facilitate the purchase and sale of equities or debt instruments. A small proportion of futures contracts results in the commodity or financial instrument underlying the contract being in fact sold or bought by the parties to the contract in satisfaction of their obligation in the contract. However, the economic function of this delivery mechanism is to ensure the contract price converges with that of the physical or cash market at maturity. This is essential to the efficiency of the futures market in its role of risk transfer and risk management mechanism. The delivery aspect of futures contracts is not designed to make them alternative primary investment or securities vehicles. Futures markets along with options and other similar markets are often described as derivatives markets in the sense that they are derived from the underlying instrument, for example, the cash securities market.

A futures contract is defined under the Futures Industry Act (Amendment) (Malaysia) as follows: "(a) an agreement that is, or has at any time been, an eligible delivery agreement or adjustment agreement; (b) a futures option; (c) an eligible exchange traded option; or (d) any other agreement, or any other agreement in a class of agreements prescribed

to be futures contracts under section 2B¹ but does not include an agreement (aa) which is (i) a currency swap; (ii) an interest rate swap; (iii) a forward exchange rate contract; or (iv) a forward interest rate contract, authorized by Bank Negara and to which a licensed institution is a party; (bb) which when entered into in a class of agreements prescribed not to be futures contracts; (cc) or which is prescribed to be an agreement that is not to be traded in on a futures market.”

Thus, the Futures Industry Act divides futures contracts into four categories:

- **Eligible delivery agreements:** These include futures contracts that seek to cover agreements that may rise to an actual obligation to effect delivery of the underlying instrument. However, it distinguishes such contracts from forward contracts by referring to the features of futures contracts that allow a party to close out its position by taking an offsetting position in the market.
- **Adjustment agreements:** These refer to futures contracts that are settled through price differential and not by delivery of the underlying instrument.
- **Eligible exchange-traded options:** This category refers to options that are traded on the futures market of an exchange company. Individual stock options would come under this category of futures contracts.
- **Futures options:** These are options over futures contracts, i.e., where exercise of the option will result in the holder of the option owning a futures contract rather than an underlying instrument like shares of a company.²

The main purpose of the futures market is to hedge risks. Thus futures markets do not arise if the price of the commodity is not uncertain. Uncertainty about prices arises from uncertainty about the supply and demand of commodities. Thus, even though most seasonally produced agricultural commodities are grown during some part of the year around the world, supply is uncertain because the quantity of the harvest may be affected greatly by weather conditions.

¹ The Ministry may, by order published in the Gazette, prescribe any agreement or class of agreements to be a futures contract.

² Securities Commission, *Malaysian Futures and Options: Regulations Module 1*, Securities Commission, Kuala Lumpur, 1999, pp. 2–7.

On the other hand, overall demand for most agricultural foodstuff, for instance, is reasonably stable since final consumption patterns do not change dramatically from time to time. However, uncertainty may arise due to the uncertainty in the supply of a substitute commodity. Even commodities which are continuously produced, such as gas, lumber, or certain metals, face uncertainty of both supply and demand. Strikes and unexpected increase in costs affect the supply. At the same time, the demand for these commodities is more uncertain than it is for agricultural products because these commodities tend to be industrial material and, therefore, subject to business cycles.³

Characteristics of a Successful Futures Market

1. The supply and demand that relate to the underlying commodity must be large. In small markets, producers and users of the commodity find it preferable to deal directly with each other rather than having someone incurring the expense of setting up a futures market.
2. Prices must fluctuate or be volatile. If they are stable or nearly so then there is no incentive for hedgers to hedge or for speculators to participate in the market.
3. The commodity traded should be quantifiable to permit standardized tests to grade quality. Quality should be described by objective criteria, accepted by the industry. To ensure that the grading of the commodities does not change, regular government inspections have to be carried out.
4. Futures trading is unlikely to succeed in noncompetitive markets where production of the underlying commodity is monopolized or where buyers are few. In such markets, the danger is too great that the cash price can be manipulated to produce artificial gains in the futures contract. Thus, objective price information should be readily available to the market participants. It should reflect the price of the traded commodity, the accuracy of the spot price, and show its relation to the futures price.⁴

³ See Hans R. Stoll, Robert E. Whaley, *Futures and Options Theory and Applications*, Southwestern Publishing Co., 1993, p. 77.

⁴ See Robert E. Fink and Robert B. Feduniak, *Futures Trading Concepts and Strategies*, New York Institute of Finance, 1988, pp. 14–16; Edward J. Swan (ed.), *Derivatives Instruments Law*, Cavendish Publishing Limited, pp. 60–61.

The above-cited features of futures contracts seem to have some similarities with the forward contract. Therefore, a distinction between these two types of contracts is necessary.

Futures Contracts and Forward Contracts

The present study has already elaborated on the concept of the forward contract. However, due to confusion between the forward and futures contract and the overlap between them in the written works of some scholars, it seems necessary to enumerate the distinctions between the two contracts.

Futures contracts began as forward contracts where buyers and sellers agreed to sell or to take delivery of a specified quality and quantity of a commodity at a specified future date. The use of forward contracts became a necessity once spot markets proved their inability to handle excess supply or excess demand for commodities. For example, the dumping of excess grain in the Chicago River of the United States became a common practice among wheat producers who were unable to sell their harvest in the spot market because of excessively low prices and the absence of adequate storage facilities.

The forward contract was only a partial answer to the problem. While it matched buyers with sellers, so that farmers were assured of a sale at a certain price and users were assured of an adequate supply of commodities at a known price, the forward contract was unable to provide a price risk mechanism due to sudden changes and was not sufficiently liquid.⁵ Thus, the need for a futures market arose. In fact, the forward contract is the fundamental building block on which futures markets are based. In other words, a futures market is a special kind of organized forward market.

However, the futures contract, as distinct from a mere forward contract entered into by any prudent producer or user of a commodity, has several special features:

1. First, it is made in a market place particularly reserved for futures trading, to which only listed members of the market are allowed, while a forward contract does not need any specific market.

⁵ See Yeo Keng Un, *Investment & You*, Pelanduk Publications, Selangor Malaysia, 1991, p. 215.

2. Secondly, all trading in the futures market is done by open outcry. That is to say, a bid or offer must be made aloud to the whole market place and may be accepted openly by any member. There is no undisclosed or selective trading. The market price is at all times known and as closely as possible reflects supply and demand among those who are trading. In the forward market in contrast, the parties have the right to conclude the contract as they wish.
3. Third, futures contract trading is confined to commodities of standard specification in standard quantities generally known as lots. For instance, the contract size of a crude palm oil future contract in Malaysia is twenty-five tons of crude palm oil. Similarly, the grade or quality of the underlying asset is specified to allow participants in the market to trade with some confidence knowing that all transactions are based on the same quality and quantity. Delivery time is also standardized in order to enhance the liquidity of the market. On the other hand, the forward contract can be tailored according to the specific needs of the contracting parties. There is no standard size and no intermediary between the parties to the forward contract.
4. The fourth and most important feature is that a party to a futures contract may, at any time before delivery, obtain a discharge of his obligations by entering into a matching or opposite contract with any member of the market for the same delivery date or month. Thus A, who has sold five lots of cotton, for instance, to B for delivery in March at \$150 per ton, may at any time before the close of trading day for March buy the same quantity from C for delivery in that month. Once this matching contract is registered with the market's clearing house, and A has asked for the two contracts to be closed out or settled, he will be fully discharged of his original obligation to deliver cotton to B and to take delivery from C.⁶ Meanwhile, in a forward contract the parties are under obligation to take delivery at the maturity date.
5. Similarly, in a futures market, the period during which delivery may occur is limited to only a few relatively brief periods during a year (which vary from commodity to commodity) and delivery must take place at a single location. Meanwhile, in a forward contract the place of delivery will be according to what is agreed upon between the parties.

⁶ See P.J. Ottino, "Oil Futures: The International Petroleum Exchange of London," *Journal of Energy & Natural Resources Law*, London, Sweet & Maxwell, 1985, pp. 1-2.

6. Finally, if a futures contract is breached, the resulting claim for damages entangles the individual parties with the future exchange itself and not with the party on the other side of the agreement. In other words, the exchange is responsible for providing the requisite compensation to the party suffering from the breach, and the exchange must undertake any action necessary to secure damages from the breaching party. So at least three parties are involved in a dispute on futures exchange and not two.⁷

Table No. 2.2 Comparison Between Futures and Forward Contracts

Item	Futures	Forward
1. Market Place	Specific market place that is reserved to listed members only	Does not need any specific market
2. Mode of Contract	Through open outcry	The parties have the right to conclude the contact as they wish
3. Subject Matter	Confined to commodities of standard specification (lots)	Tailored according to the specific needs of the contracting parties
4. Discharging of Obligation	Possible to discharge obligations by entering into a matching contract	Parties are under obligation to take delivery at the maturity date.
5. Delivery Time	Limited to only brief periods during a year.	According to what agreed upon between the parties
6. Breach of Contract and Claim for Damages	Entangles the individual party with the Futures Exchange and not the party on the other side of the agreement.	The settlement of the dispute will involve the two contracting parties only.

To illustrate the characteristics of a futures contract from real practice, let us consider the crude palm oil futures contract specifications as they are applied by the Commodity and Monetary Exchange of Malaysia (COMMEX) as of November 2000.

⁷ See S. Craig Pirrong, David Haddock and Roger Kormendy, *Grain Futures Contract: An Economic Appraisal*, Kluwer Academic Publishers, Boston, 1993, p. 2.

Contract size: 25 metric tons
 Delivery Months: current and the next five succeeding months, and thereafter alternate months up to twelve months forward.
 Price Quotation: Malaysian Ringgit per metric ton.
 Minimum Price Fluctuation: RM 1.00 per metric ton.

Daily Price Limits: RM 100 per metric ton above or below the Settlement Prices of the preceding day for all months, except current month. Limits are expanded when the Settlement Prices of all three quoted months, which immediately follow the current month, in any day are at limits as follows:

<u>Day</u>	<u>Limit (RM)</u>
First	100
Second	150
Third	200

Daily price limits will remain at RM 200 when the preceding day's settlement prices of all three quoted months immediately following the current month settle at a limit of RM 200.

Reportable Position: 100 or more open contracts, either long or short, in any one-delivery month.

Speculative Position: 500 contracts net long or net short, for any delivery months combined.

Transaction Limit: Each single transaction shall not exceed twenty lots.

Last Trading Day: A contract month expires at noon of the fifteenth of the month; if the fifteenth is a nonmarket day, it expires the preceding business day.

Tender Period: First business day to the twentieth day of the delivery month; if the twentieth is a nonmarket day, the preceding day.

Contract Grade and Delivery Points: Crude Palm Oil of good merchantable quality, in bulk, unbleached, in Port Tank Installations located at the option of the seller at Port Kelang, Butterworth/Prai and Pasir Gudang. Free Fatty Acids (FFA) of Palm Oil delivered into Port Tank Installations shall not exceed four percent and from Port Tank Installations shall not exceed five percent moisture and impurities shall not exceed 0.25%.

Deliverable Unit: Twenty-five metric tons, plus or minus not more than two percent. Settlement of weight differences shall be based on the simple average of the daily Settlement Prices of the delivery month from: (a) the first business day of the delivery month to the business day immediately preceding the last day of trading, if the tender is made on the last trading day or thereafter.

Trading Hours: Malaysian Time, on each business day
 10:30 a.m.–12:30 p.m.
 3:00 p.m.–6:00 p.m.

To illustrate the above situation let us examine the following example to see how the forward contract is needed and how it falls short of solving some problems associated with commodities trading and, therefore, why the need for futures market arises. It is the example of a farmer and a textile mill.

A cotton farmer has estimated that he will harvest 50,000 pounds of cotton. He also knows from discussions with fellow farmers that local merchants are presently willing to pay sixty cents per pound for the grade of cotton he expects to produce. Based on his expenses for seed, labor, fertilizer, machinery and so on, his cost is fifty cents per pound. The farmer is concerned that a drop in prices from the present levels may cut deeply into his year's earning. A drop of more than ten percent per pound would actually produce a loss on each pound he harvests. In a world that has no forward or futures market, the farmer must wait until the harvest of his cotton before selling his cotton at whatever price prevails at that time.

To avoid the possibility of loss, the farmer calls a textile mill and asks the mill manager about the price that he could guarantee now for cotton that will be delivered in three months time. The manager of the textile mills is concerned that recent adverse weather will result in a smaller than expected supply and higher prices at harvest time. Since he has already committed himself to deliver raw material of cloth to a clothing manufacturer in the late fall, he is concerned that a rise in the price of the raw cotton will reduce or eliminate his profit margin. He contacted the farmer and informed him that he would be pleased to be guaranteed the supply of raw cotton in October at today's price of sixty cents per pound. The farmer agreed after little haggling. Thus, the farmer agreed to deliver to the textile mill 50,000 pounds of cotton in October and the terms of that agreement are stipulated in a formal contract known as the forward contract. The terms of the forward contract include the following;

- The quantity to be delivered
- The particular quality of the cotton to be delivered
- The date on which the cotton is to be delivered
- The location at which delivery is to be made
- The terms of payment upon delivery.

Thus the forward contract represents a formal agreement between two parties to provide and to take delivery of a specific quantity and quality of a commodity at a specified place and future time.⁸

However, the business conditions might go beyond the above situation. Let us introduce some new elements into the picture. A favorable change in weather brings about a decline in spot cotton prices to fifty-five cents per pound. The farmer in the above example is pleased by his early decision to enter into the contract because it will have allowed him an additional profit of five cents per pound. The textile mill manager, however, is regretting his decision because he would have been able to buy his cotton five cents cheaper had he not entered the contract.

On the other hand, suppose the manager of the textile mill becomes convinced that the improved weather outlook will bring about a further deterioration in price. He wants to cut short his loss and has two ways of doing so. He can ask the farmer to dissolve the contract, but the farmer would be foolish to do so without requiring the textile mill to pay him a penalty equal to the difference between the sixty cents per pound contract price and the present price of fifty-five cents per pound. Even with this penalty, the farmer has no assurance that he will find another buyer. So, unless he believes that the cotton price has bottomed out, he will hold the textile mill to the contract. The textile miller manager's second choice is to look for someone else to buy the contract from him. To do this the manager will have to pay the buyer five cents per pound to compensate him for the difference between the sixty cents per pound the buyer will have to pay the farmer and the fifty-five cents per pound at which he would be able to buy cotton in the open market. A local businessman hears about the textile mill's problem.

From the above it is clear that the futures contract is a special kind of forward contract. The study of futures contracts from the Islamic perspective could be based on two alternatives:

The first alternative will be the legality of the conventional forward contract in Islamic law as it was elaborated and established at the beginning of this study. Still, some scholars maintain that the conventional forward contract is illegal in Islamic law although there is no evidence to support such a claim. They have supported their claim by relying on some general principles such as the prohibition of *bay' al-kali' bi al-kali'*, although a

⁸ See Robert E. Fink and Robert B. Feduniak, *Futures Trading Concepts and Strategies*, Institute of Finance, New York, 1988, pp. 3-5.

correct interpretation of these principles clearly shows that they are not applicable to the forward contract in commodities, the specific issue of our discussions.

Therefore, since we have already established the legality of the forward contract in physical commodities in particular, the possibility of a futures commodity exchange from an Islamic perspective will arise and will be addressed in this part of the study. On the other hand, the second alternative will be grounded on *salam* and *'istiṣnā'* as an alternative to the conventional forward contract.

A Brief History of the Futures Commodity Market

Commodities are common raw materials and foodstuffs, which in their bulk forms provide basic elements in consumable goods when manufactured or processed. The first traded commodities were primarily agricultural products; later they were joined by the metal-based commodities needed in farming, tool-making, weaponry, as well as precious metals required for jewelery and, more importantly, oil and its derivatives. Commodities comprise virtually all of the most widely traded raw materials upon which commerce is based.

The origins of futures trading have been ascribed to various past cultures and economics systems. However, the first system of trading of futures delivery recognizably similar to modern exchanges was developed in Japan in the seventeenth century. In the Western world, "to arrive contracts of sale" date from 1780 in the Liverpool cotton trade and many existed earlier. In the United States, the Chicago Board of Trade was formed in 1848, and in 1865 the foundations for all modern futures contracts were laid down in contracts by introducing grain agreements which standardized quality, quantity, date, and location of grain contract. As a result, the only condition left for the contract was the price, which was open to negotiation by both parties to the contract. By the early 1970s the world commodity and financial markets had been subjected to dramatic political, economic, and regulatory changes, which paved the way for the introduction of new financial futures markets.⁹ Nevertheless, the present study is mainly concerned with the commodity futures market.

⁹ See David Courtney and Eric C. Bettelhim, *An Investor Guide to the Commodity Futures Markets*, London, Butterworths, 1986, p. 3; Anthony F. Herbest, *Commodity*

The Kuala Lumpur Commodity Exchange (KLCE) is perhaps the first modern commodity market in the Islamic world. Thus, prior to the establishment and operation of the KLCE in 1980, there was a quasi "Futures Exchange," namely the Malaysian Rubber Exchange (MRE), which was set up in 1962 to provide facilities for trading rubber futures on what was referred to as the "whispering trading system," by clearing and settling contracts on a fortnightly basis.

However, the MRE was not regarded as suitable for the industry, which required a more open, transparent, and efficient market. Moreover, considering that Malaysia was the largest producer and exporter of rubber, palm oil, and tin, and the fact that a number of commodity futures commission houses, some of which were foreign-owned, were offering overseas commodity futures to the public, the Malaysian government in collaboration with the private sector took the initiative to establish a legal framework for a modern futures exchange that could provide an efficient price-discovery mechanism and meet the risk-management needs. Thus, the Commodities Trading Act was enacted in 1980 to provide for the establishment of a commodity exchange and to control trading in commodity futures contracts.¹⁰

The Exchange started operation on the twenty-third of October, 1980, with crude palm oil as its first contract. However, in 1984 the market witnessed a crisis due to some weakness in the legal framework and structural and operational deficiencies in the system. The Malaysian futures industry model was largely based on the Hong Kong Commodity Exchange and the Sydney Greasy Wool Exchange. These models, in turn, were structured along the lines of the British trade denominated futures markets model and therefore, were found unsuitable under the Malaysian speculative environment.¹¹ The present study will elaborate on the issue when it addresses speculation in the futures market.

Futures Markets Methods of Analysis, and Risk Management, John Wiley & Sons, 1986, New York, p. 2; The Reuters Financial Training Series, *An Introduction to Derivatives*, p. 40.

¹⁰ See Seyed 'Abdul Jabbār Shahābudīn, "Regional Experience of Exchanges (KLCE/KLFM, SIMEX, SFE)," presented at *The 1995 Malaysian Capital Markets Conference*, 12–13 June, 1995, The Kuala Lumpur Hilton, organized by Securities Industry Development Center, Securities Commission and managed by Asian Strategy and Leadership Institute, pp. 1–2; Seyed 'Abdul Jabbār Shahābudīn, "Futures Market in Malaysia," *Financial Derivatives and Risk Management Workshop*, 7–10 October 1996, the Legend Hotel, pp. 1–4.

¹¹ *Ibid.*

Following the 1984 crisis there was an overhaul in the Commodity Trading Act of 1980 for futures trading in Malaysia. The Act was repealed and replaced by a new Act, entitled the Commodities Trading Act of 1985, which provides for the establishment of the Commodities Trading Commission (a statutory body) with wide powers. Under the previous arrangement, the Commodities Trading Council acted as a department of the Ministry of Primary Industries. A new clearing house, the Malaysian Futures Clearing Corporation (MFCC) with an issued capital of twenty-five million Malaysian Ringit was established with seventy percent of the equity being taken up by the Kuala Lumpur Commodity Exchange (KLCE) and clearing members, while the balance was taken up by a consortium of banks. Under the new structure, the management of the KLCE and MFCC was strengthened to provide for a clear authority, clear communication and coordination of action.¹²

The Exchange admitted individuals to trade on the floor in 1988 and since then their contribution to the crude palm oil (CPO) market has increased to thirty percent of the volume. The Exchange and the clearinghouse emerged stronger after the restructuring and more effective in performing their risk-management functions. The volume of crude palm oil futures has been increasing at an average rate of sixty percent since it was relaunched in 1986.¹³ The market is sufficiently liquid for the purpose of trading in The Association of Southeast Asian Nations (ASEAN) as well as in other palm oil producing and consuming countries. Thus, the new strong foundations and the success of the crude palm oil futures market provided the impetus for the KLCE to venture into financial futures.¹⁴

On August 19, 1992, the KLCE, with the support of the government authorities, incorporated a wholly owned subsidiary called the Kuala Lumpur Futures Market Sdn Bhd (KLFM), which was later renamed the Malaysia Monetary Exchange Bhd (MME) in mid 1995. On May 7, 1996,

¹² Seyed 'Abdul Jabbār Shahābudīn, "Futures Market in Malaysia," *Financial Derivatives and Risk Management Workshop*, 7–10 October 1996, the Legend Hotel, pp. 2–4.

¹³ Seyed 'Abdul Jabbār Shahābudīn, "Regional Experience of Exchanges (KLCE/KLFM, SIMEX, SFE)," *The 1995 Malaysian Capital Markets Conference*, 12–13 June, 1995, The Kuala Lumpur Hilton, organized by Securities Industry Development Center, Securities Commission and managed by Asian Strategy and Leadership Institute, pp. 6–7.

¹⁴ Seyed 'Abdul Jabbār Shahābudīn, "Financial Derivatives and Risk Management," *Workshop organized by the Securities Commission and The Options and Clearing Corporation*, 10–13 Oct., 1995, p. 3.

the Minister of Finance approved the establishment and operation of the MME as a futures and options exchange company and the three months KLIBOR (Kuala Lumpur Interbank Offered rates) futures contract was launched on May 28, 1996. On November 9, the KLCE was renamed the Commodity and Monetary Exchange of Malaysia (COMMEX) in preparation for the merger with the Malaysian Monetary Exchange. The merger took place on December 7, 1998.¹⁵

Scope of the Futures Market

It must be noted that in the evaluation of futures contracts from an Islamic point of view, we are primarily concerned with commodity futures as the most probable area in which an Islamic alternative is possible. Therefore, we are not concerned with the broader concept of commodity used by some writers,¹⁶ which includes currencies, bonds, interest rates, and other financial futures. We are interested only in the physical commodities market. Thus, the futures contract in currency, for instance, is beyond the scope of this study and of the Islamic finance in general. Even the forward currency market as it is in the conventional form is unacceptable in the *shari'ah*, where prompt exchange or hand-to-hand delivery is a fundamental condition in currency trading.

Physical commodities are generally divided into metal, energy products, grain, and soft commodities such as coffee, cocoa, sugar, or cotton. However, from an Islamic legal analysis another classification of all the above kinds of physical commodities is necessary. Thus, a distinction will be made between foodstuffs and non-foodstuff commodities. This is necessitated by the *hadith* of the Prophet (PBUH) to the effect, "Do not resell foodstuff before taking possession."¹⁷ Based on this, there is a wide debate among Muslim scholars regarding the legality of selling something before taking possession and whether this prohibition is limited to foodstuff or generalized to all commodities. Since some of the commodities in the futures markets are foodstuff, it is necessary

¹⁵ Securities Commission, *Malaysian Futures and Options Regulations Module 1*, p. 5.

¹⁶ See for instance, T.H. Stewart (ed.), *Trading in Futures*, Woodhead Faulkner Limited, Cambridge, fifth edition, 1989, p. 1.

¹⁷ *Sahih Muslim*, vol. 10, p. 169.

to investigate whether it is permissible to trade them or not in the futures market. Whether the above *ḥadīth* is based on a rationale or *'illah* and whether this *'illah* is still present or not. These are the themes to be addressed.

This classification is necessary whether we adopt the conventional forward contract or *salam* as the basis for the permissibility of futures contract trading. Moreover, if the futures market is based on *salam*, an elaboration on the parallel *salam* is necessary.

Economic Benefits of Futures Contracts

Some Muslim economists have stressed the need for a futures market. Obaidullah, for instance, argues that it might be safer for Islamic scholars to be on the side of conservatism by declaring these contracts to be illegal. However, such a position may have serious consequences for Islamic business in the long run. Thus, in an increasingly competitive and sophisticated business environment, denying Muslim businessmen the use of a flexible and powerful array of instruments may place them at a disadvantage.¹⁸

Fahīm Khān has also argued in favor of an Islamic futures market. However, his attempt has been affected by the prevailing differences of opinion regarding some of the issues constituting the legal foundation of futures contracts. Sometimes he even rejects the opinions that are in line with the general principles of the *sharī'ah* for the simple reason that they are not preferred by some modern scholars. Thus his study has many limitations.¹⁹

Similarly, Munzir Khaf has argued in favor of such a market while explaining the features of futures contracts to Muslim jurists and discussing the legality of futures contracts at the Islamic Fiqh Academy. He has pointed to the fact that the futures market is the only market where large business deals are concluded and is an effective means for price discovery. Moreover, he warns that even if the Fiqh Academy passed a negative decision on these markets, an Islamic alternative must be

¹⁸ Obiyathulla Ismath Bacha, "Derivatives Instrument and Islamic Finance: Some Thoughts for Reconsideration", p. 9.

¹⁹ See Fahīm Khān, *Islamic Futures and Their Markets with Special Reference to Their Role in Developing Rural Financial Market*, Islamic Development Bank, Jeddah, Saudi Arabia, 1995.

sought due to the importance and real benefits and objectives of these markets, especially in the commodities market.²⁰

This stand has been echoed by ‘Abdel-Ḥamīd al-Ghazālī who stresses the real benefits of futures markets, especially their effect on supply, cost, and business planning and the fact that these genuine benefits should be taken into consideration.²¹ Indeed, this concern voiced by the economists has influenced some jurists attending the above forum, such as ‘Abd Allāh bin Beh and Mukhtār al-Salāmī, They argued that there is a real need for such a market by pointing out that modern Muslim jurists must address such problems according to modern circumstances, and scholars must not limit themselves to quote what is recorded in classical *fiqh* and pass a prohibitive decision.²²

Unfortunately, this concern has not been reflected in the final resolution of the Academy. Perhaps this was due to the stand of some scholars, such as Ṣiddīq al-Ḍarīr who asserted that any possible alternative to futures contracts should be based on *salam* and must fulfill its conditions.²³ It should be noted that Khaf in his elaboration pointed that *salam* in its actual form could not serve this purpose due to the fact that in *salam* the price must be paid in advance.²⁴

On the other hand, a futures exchange provides some specific benefits to the economy as a whole, such as risk shifting, price discovery, enhanced liquidity, and increased information flow. Normally, the producers or manufacturers of a product would like to determine by themselves the price of their product, but in terms of economics, the fixed price system results in resource misallocation and high cost, etc. Primarily, agricultural products are subject to a market price system, which sets the equilibrium between production and consumption. This is because the volume of supply and demand for most agricultural products is beyond the scope of regulation of either government or producers. Commodity exchanges have been established in order to avoid losses due to price fluctuations that can result from the law of supply and demand.²⁵

²⁰ *Majallat Majma. ‘al-Fiqh al-Islāmī*, 1991, no. 7, vol. 1, pp. 620–621.

²¹ *Ibid.*, pp. 639–640.

²² *Ibid.*, pp. 626–627, 641.

²³ *Ibid.*, p. 634.

²⁴ *Ibid.*, p. 641.

²⁵ Hiromu Takahashi, “Commodity Futures Trading and its Role in Business Management,” *The Proceeding of the Malaysian International Symposium on Palm Oil Processing*

Risk shifting was the main reason for the development of futures markets. Typically, hedgers use futures to reduce their exposure to price fluctuations. The futures market permits commercial producers, processors, end users, and traders to look for a price for their products. Industrial processors, for example, may choose to eliminate the price risk involved in buying, storing and eventually using their raw materials. In a market economy, manufacturers run the risk of large changes in the prices of the raw material or the final products between the time they buy their raw material and the time they sell their final products.²⁶

Liquidity is another major benefit of the futures market. Thus, if risk is to be transferred efficiently, there must be a large group of traders ready to buy and sell. When a hedger wants to sell futures contracts to protect his business position, he cannot afford to wait around for a long time for a buyer. He needs to know whether he will be able to effect the transaction quickly whenever he wishes to do so. The futures exchange brings together a large number of traders and speculators, thus making quick transactions possible.

Moreover, the development of production techniques of the commodities, which are adaptable to futures trading, must be susceptible to standardization and grading. The quality in each grade must also be standardized. Therefore, producers should work to improve production techniques so that their commodities may have proper grade and standard to be traded in a favorable market. In addition, as producers and organizations connected with commodities markets make efforts to improve their own situation, the level of education and knowledge about the marketing of their products will be elevated.²⁷

Referring to some of the advantages considered by the Malaysian government for the establishment of its own Commodity Futures Exchange, we may mention that, considering the fact that Malaysia is the largest producer and exporter of rubber, palm oil, and tin, to allow a number of futures commission houses (owned sometimes by foreigners) to offer overseas commodity futures to the public represents, in fact, a disadvantage to the national economy. The establishment of a local com-

and Marketing 17-19 June 1976, edited D.A. Newal, The Incorporated Society of Planters, Kuala Lumpur, 1977. p. 515.

²⁶ See International Trade Center UNCTAD/GATT, *Cocoa: A Trader's Guide*, Geneva, 1987, p. 140.

²⁷ Hiromu Takahashi, "Commodity Futures Trading and its Role in Business Management," 515.

modities exchange will provide local producers with facilities to hedge or transfer their risks as well as guaranteeing them leverage in the determination of price trends. Moreover, such an exchange can complement the existing principal centers overseas—namely Chicago, London, and Rotterdam—in offering arbitrage opportunities for the price differences and time-zone variations that exist among these markets.²⁸

Thus, Dato Bek Neilsen, for instance, said:

Long gone are the days of the palm oil pool in London and it is visualized that this exchange (KLCE) will serve as an important market for palm oil, right at the main area of its production and we may rightly ask what could be more natural than to bring home, where it belongs, that which has for so long been centered abroad... the Malaysian palm oil industry has now reached the stage where it must take control of its own destiny.²⁹

Normally when a country develops, it is inevitable that local governments will want to retain a greater influence over the price paid for what they produce. The logic goes something like this: if we are one of the largest producers of a specific commodity, why should the price be determined by traders and speculators on the other side of the world? Why can we not have a futures exchange here that is closer to the source of supply and where spin-off activity from trading—such as employment opportunities that will be created through establishing an exchange and a clearing house—will benefit our own people?³⁰

However, Muslims have ignored this obvious logic with regard to the most fundamental commodity in the modern world, namely oil and its derivatives. Thus, Edward J. Swan, for instance, after addressing some of the economic benefits of derivatives in oil trading observed:

However, it is clear that these advantages are not being exploited in the market of all the countries that produce or consume this important commodity. Indeed the benefits that flow from the derivatives trading are concentrated in a very few countries. The principal exchanges for trading energy are in New York, London and Singapore. Other off-exchange

²⁸ See Yeo Hwee Ying, "The Kuala Lumpur Commodity Exchange (KLCE) Case Study of the Crude Palm (CPO) Futures Market," Singapore Conferences on International Business Law, Conference 3: *Current Development In International Securities, Commodities and Financial Futures Markets*, Shangri-La Hotel, Singapore, Organized by the Faculty of Law National University of Singapore, Part two, p. 213.

²⁹ Dato Bek Neilsen, International Symposium on Commodity Futures Trading, Kuala-Lumpur 21–22 October, 1980, p. 8.

³⁰ See Doreen Soh, *Invest in Commodities, Gold and Currencies*, Times Books International, Kuala Lumpur, 1995, p. 10.

markets flourish in London, the US and various countries in Europe and have following in countries of the Far East. However, many of the producing countries, particularly in the Middle East and Latin America, seem to be excluded from the benefits that the derivatives trading in oil can bring. This situation cannot remain indefinitely. It must be becoming increasingly clear to those in economic decision making positions in producing countries that there are substantial benefits, in terms of both increased revenue and control over pricing and distribution which derivatives trading produce. It can only be a matter of time before they seek to obtain these benefits for their own economies.³¹

Based on the above, it is clear that the establishment of an Islamic derivative exchange for oil trading is a necessity given the fact that the majority of the members of the organization of oil producing countries (OPEC) with the exception of Venezuela are Muslim countries.³²

On the other hand, considering the fact that Islamic financial institutions could not invest in currency, bonds, and other interest-based markets, establishing the permissible part of a derivatives commodities market will definitely open a wide range of investment opportunities for these financial institutions.

Some of the economic benefits that have encouraged the Malaysian government to establish the Kuala Lumpur Commodity Exchange are the growing need of the industry for a market for the purpose of price discovery after realizing the inefficiency of the old system. In the past, local traders in Malaysia had to rely on the quoted price of related commodities in distant terminal markets in Rotterdam, London, and Chicago. Moreover, a local exchange provides hedging facilities to market participants against the vagaries of price fluctuations. Before that, local palm oil traders had to rely on soybean futures for hedging purposes. Malaysia's previous reliance on foreign futures market might have led to inefficient price transmission (due to the distance factor), irrational production, and stockholding decisions.³³

Moreover, by setting up her own futures market, Malaysia will earn much foreign exchange from foreign sources in the form of deposits margin and brokerage commissions. Conversely, the remittance of such

³¹ Edward J. Swan (ed.), *Derivatives Instruments Law*, Cavendish Publishing Limited, p. 87.

³² See the weekly news magazine, *Times*, October 9, 2000, vol. 156, no. 14, p. 40.

³³ Fatimah Mohd, Arshad and Zainalabidin Mohamed, "The Efficiency of the Crude Palm Oil (CPO) Futures Market in Establishing Forward Prices," *The Malaysian Journal of Agricultural Economics*, vol. 8, December, 1991, p. 26.

monies overseas by local investors trading on futures markets outside the country will also be reduced.³⁴

Furthermore, it serves to promote Kuala Lumpur as a viable center for the conduct of international trade in commodities. Bearing in mind that Malaysia and the ASEAN region in general produce many of the commodities fundamental to the needs of mankind, it is logical therefore that these commodities are traded on terminal markets at the origin rather than in the center of consumption. Thus, the establishment of an exchange in Kuala Lumpur will alter the balance of power in the market place and restore to the producer a meaningful role in the price determination process.³⁵

The Clearinghouse and the Futures Market

One of the most important organizations of futures exchanges is the clearinghouse. In centralized marketplace trading where contracts are standardized and executed continuously throughout the day at great speed, there is a need for an organization to record transactions. Furthermore, the confidence of all parties that the contractual obligation entered into by buyers and sellers will be honored is crucial to the success of the futures market system.

In some futures exchanges the clearinghouse is an integral part of the exchange and members of that exchange provide the guarantee of financial performance mutually. In other exchanges the clearinghouse is an independent company and the guarantee fund is provided by the share capital and reserves of that company. The present study will take as an example the structure and functioning of the Malaysian Derivatives Clearing-House (MDCH), which is an independent entity. It is a limited liability Company incorporated under the Company Act.

The clearinghouse in relation to the futures market is defined in the Futures Industry Act as a company or an association or organization

³⁴ See Yeo Hwee Ying, "The Kuala Lumpur Commodity Exchange (KLCE) Case Study of the Crude Palm (CPO) Futures Market," Singapore Conferences on International Business Law, Conference 3: *Current Development In International Securities, Commodities and Financial Futures Markets*, Shangri-La Hotel, Singapore, Organized by the Faculty of Law National University of Singapore, Part Two p. 212.

³⁵ See 'Abd. Rahin Aki, "Tin and the Kuala Lumpur Commodity Exchange," *International Symposium on Commodity Futures Trading*, Kuala-Lumpur, 21-22 October, 1980, p. 1.

forming part of the futures exchange that clears, settles, and registers futures contracts; and it makes adjustments to the contractual obligations out of those futures contracts.³⁶ Clearing house facilities in relation to futures market include any one or more of the following in relation to the futures contracts traded on that futures market: (a) matching of trades; (b) registration; (c) settlement; (d) guaranteeing or being a counterparty; and margining.³⁷

The evolution of the Malaysian clearing system started with the Kuala Lumpur Commodities Clearing House Sdn Bhd (KLCCH), which was incorporated in June 1980 as a joint venture between International Commodities Clearing Holding of London and several leading banks in Malaysia. From its inception until 1984, the KLCCH was independently and separately run from the KLCE. Upon revamping in 1985 after the crisis, it was decided that an independent clearing system would not be in the best interest of the industry and hence the Malaysian Futures Clearing Corporation (MFCC) was established. This new clearinghouse is structurally different from its predecessor in that the KLCE and the clearing members own seventy percent of its equity.³⁸

The clearinghouse serves several important functions, such as the registration of the different contracts concluded, substitution of counterparties, guarantee of performance, settlement of contracts, management of physical delivery, and monitoring of members' positions. Thus, the MFCC progressively records the deal being concluded on the trading floor by means of a trading slip signed by both the buyer and the seller. The deals are processed overnight and the next morning a statement is issued to each clearing member detailing the trades registered in their account. Once the clearinghouse accepts the contract for registration, it will substitute itself as the counterparty to the contract. It becomes the buyer to the seller and the seller to the buyer. This is important in facilitating the settlement of contracts and the buyer will have a contract with the clearinghouse to purchase the commodity and the seller will have a contract with the clearinghouse to sell the commodity. This function, termed *novation*, is one of the distinguishing features of exchange traded futures and options markets.³⁹

³⁶ Futures Industry Act, 1993, p. 2.

³⁷ Futures Industry (Amendment) Act 1995, p. 3.

³⁸ See Yeo Hwee Ying, "The Kuala Lumpur Commodity Exchange (KLCE) Case Study of the Crude Palm (CPO) Futures Market," p. 219.

³⁹ Rodney Parker, "Clearing and Guarantee Function," *Commodity Futures Course*,

Given that the performance of the contract is deferred to future dates and the parties have not paid for those obligations if we exclude the margin, which is about five percent, there is a need to guarantee the performance of the contracts so that parties could trade freely without having to concern themselves about the credit worthiness of their counterparties or the ability of their members to fulfill their contractual obligations. The clearinghouse also monitors clearing members' positions daily to ensure that they are not extending themselves by building up large positions that they would have difficulty serving or that could pose dangers to the market as a whole. Thus, it ensures that the clearing members have adequate liquidity to meet potential margin calls as and when required.⁴⁰

The above functions of the clearinghouse, such as the registration of the different contracts concluded, settlement of contracts, management of physical delivery, and monitoring of members' positions, are largely administrative issues designed to facilitate the smooth running of the market. Obviously, there is no clear objection to these functions from an Islamic point of view and they could be adopted under the concept of *maṣlaḥah*. However, substituting the counterparties in the contract involves a contractual matter but could also be accommodated under the concept of *al-wakālah bi 'ajr* (agency with determined fee). The clearinghouse substitutes both the buyer and the seller in the contract and guarantees its performance.

It is very important that the different institutions supervising and regulating the futures market collaborate and coordinate their activities in order to avoid any excessive speculation.

Hedging and the Futures Market

A hedge may be defined "as the opening of a futures position opposite to that held in the physical commodity."⁴¹ A hedger on the other hand is a person who typically engages in the production, distribution, processing, storing or consumption of actual commodities. The hedger uses

Organized by Commodities Trading Commission, 14–18 March, 1995, Kuala Lumpur, p. 23; Security Commission, Malaysian Futures and Options: Regulations Module 1, p. 17.

⁴⁰ Ibid.

⁴¹ T.H. Stewart (ed.), *Trading in Futures*, Woodhead-Faulkner, fifth edition, New York, 1989, p. 19.

the futures markets to minimize the risk of losses from price changes inherent in owning the commodities. Generally, a hedger assumes a position in the futures market which is in opposition as well as equal to what he already holds in the physical market.⁴²

In contrast, a speculator does not have any ongoing commercial interest in the physical commodity. A speculator is one who is willing to take risks by speculating on the future course of prices. A speculator is solely motivated by profit and will generally not be interested in using the commodities in which he trades.⁴³

In free market economies the prices of many primary goods fluctuate with the demand and supply conditions. Prices are also affected by the transportation and storage of the commodity during its physical distribution. Hedging plays an important role as a tool of risk management. It is a process used to minimize commodity marketing and processing losses that arise due to adverse price fluctuations.

A producer (farmer or mining company), a processor, or a consumer may all need to ensure themselves against unforeseen fluctuations in the price of raw materials which they sell or use as the basis of their business; an exporter/importer may additionally want to ensure his safety from currency fluctuations that might adversely affect his profit margins. In all these cases, the speculator acts as the counterparty to accept the risk in the hope of making a profit by predicting the trend of the market. For example, for a farmer who is growing corn and is planning to sell it in six months, the price may be either lower or higher than what he expects now or anticipated when he planted his corn. If the price turns out to be significantly lower, the farmer may be forced to sell the corn at a price that does not even cover production costs, which may end in bankruptcy. If, on the other hand, the price turns out to be higher, the farmer would make unexpected profits.⁴⁴

Alternatively, an airline company may wish to set passage fares that will remain fixed for long periods of time. To fix a profitable rate of fares, they must estimate their expected costs. However, they are at the same time subject to suffer the risk of unexpected rise of cost that may squeeze profit margins. The cost of jet fuel for a typical carrier accounts

⁴² See David A. Chaikin and Brendan J. Mother, "Commodity Futures Contracts and the Gaming Act," *Lloyd's Maritime and Commercial Law Quarterly*, (1986) 2, pp. 391–392.

⁴³ *Ibid.*

⁴⁴ See Franklin R. Edwards and Cindy W. Ma, *Futures and Options*, pp. 102–103.

for about seventeen percent of the total expenses. A one per cent per gallon rise in jet fuel prices, therefore, increases costs substantially and can have a significant effect on earnings per share. Thus, the farmer and the airline carrier are both exposed to price risks.

The ultimate goal of any business is, of course, to make profits. It is only the price variation in output and input that brings about variation in revenues and costs. Changes in sales revenue can occur either because of changes in prices or because of changes in the quantity sold. For example, the above farmer may have anticipated growing 500,000 bushels of corn, but due to unfavorable weather conditions managed to harvest only 300,000 bushels. Thus, even if he correctly anticipated corn prices, he would still find his sale revenue drastically reduced. This type of risk is called quantity risk and it cannot be hedged with great precision, whether through futures, options, or any existing forward instruments. So it should be kept in mind when designing a hedging strategy.⁴⁵

Addressing the issue, many Muslim scholars maintained that hedging is valid from the *shari'ah* point of view because it allows traders to hedge themselves against unforeseen price fluctuations. That is why it was upheld by the participants in the Sixth al-Barakah conference that hedging is permissible if the issue of contract is permissible.⁴⁶

Speculation and the Futures Market

The issue of speculation is one of the reasons cited most frequently to invalidate futures contracts. The issue is a problem not only in Islamic finance. It is also a controversial matter in the conventional system. It is sometimes difficult to distinguish between hedging (a needed factor to manage risk) and speculation, which is generally connected with crises and market crashes. A similar confusion exists between speculation and investment. Speculation is also connected with gambling. But what aggravates the situation is the fact that a limited level of speculation is not only desirable but is a necessity for the smooth functioning of any exchange. Thus, eliminating speculation altogether, whether in

⁴⁵ Ibid., p. 103.

⁴⁶ See *al-Fatāwā al-Iqtisādiyyah al-Şādirah 'an Nadwat al-Barakah li al-Iqtisād al-Islāmī*, edited by Abd al-Sattār Abū Ghuddah and others, Dallah al-Barakah, Jeddah, 1995, p. 42.

ordinary sales or derivatives markets, is impossible. Now the question arises as to how and where to draw the line between this limited scale of speculation and the unlimited one.

The primary purpose of a futures market is to facilitate hedging. However, if there were hedgers in the futures market in order to ensure a permanent balance between short and long hedgers, there would be little need for speculators. But this is not the case. In most markets, hedgers tend to concentrate on one side of the market, either long or short, but for the market to function, both long and short positions must exist. Thus, in a market without speculators, hedging would be, at least, very difficult and at the worst impossible.

Addressing the issue, Kamāli wrote:

Defining speculation or identifying the speculator is always difficult and many have stated that no clear definition can be given. This is because the distinguishing line between investment, speculation, and gambling are not always clear, and ambiguity tends to persist regardless of definition. What can be said, however, is that speculation deals in risks that are necessarily present, but gambling creates the risk that would otherwise be nonexistent.⁴⁷

Another scholar who addressed the issue of speculation in a futures market is Fahīm Khān. He divided the forms of speculation into two kinds: the first kind of speculation is unrelated to any real activity and is meant to be merely a financial or monetary transaction or a nonproductive exchange. It is simply a way of making good guesses with no intention of receiving or delivering. This kind of speculation, according to Fahīm Khān, is unacceptable, while a second form of speculation is considered acceptable. The second kind occurs when speculation, a part of some real activities, helps to shift risks from the producers unable to bearing all the risk, to those who can afford to bear it. Moreover, according to Fahīm Khān, speculation (a part of a deal to provide liquidity to farmers to increase the volume of their production) will also be a desirable and permissible activity despite the fact it involves speculation in futures prices.⁴⁸

From the two kinds of speculators identified by Fahīm Khān, one may ask if the acceptable form of speculation is only that which will

⁴⁷ Kamāli, "The Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments," *IJUM Journal of Economics & Management* 7, no. 2, 1999, p. 77.

⁴⁸ Fahīm Khān, *Islamic Futures and Their Markets*, p. 46.

allow farmers and producers to shift their risk to those who would be ready to bear these risks? And is it possible to have an Islamic futures market with only hedgers? However, Fahim Khān did not explain how to differentiate between his two kinds of speculators except by the suggestion that they will have to establish that they are bona fide traders/producers and would deal in real goods and services and would not merely gamble.⁴⁹

Some other scholars have tried to make the distinction between speculation and games of chance on the grounds of the availability of information. Therefore, it is only in the absence of information or under uncertainty that speculation is akin to a game of chance and is reprehensible. This suggests that speculation is a process that relies on the analysis of a lot of economic and financial data, companies' financial reports, information about management skill and aptitude as well as the personal profile of decision makers. All this information is analyzed before a decision is taken.⁵⁰

Nevertheless, the issue seems to be not totally out of hand. A well-regulated market might reduce speculation to an acceptable level. Thus, some scholars have come up with some propositions on how to curb speculation. While suggesting some possible means to curb speculation, Hussin Salamon, for instance, maintains that speculative business instruments must be excluded from the Islamic model. These include, he suggested, margin trading, short selling, market rigging, manipulation, cornering, and rumor and options trading. Moreover, he observed that to differentiate between speculation and investment is not easy. The word investment connotes that the arrangement will continue for a long time and that the principal is safe, while speculation connotes speed and high risk. Thus, he suggested that the appropriate time duration for share holding, for instance, should be six months while it would be ideal if a one-year period could be considered.⁵¹

However, given the fact that time and risk are relative, any suggested period is relative. For example, a sum of money is used to buy a house with the intention of renting it out and selling it when the price rises

⁴⁹ Ibid.

⁵⁰ Ahmad Abdel Fattah, "Toward an Islamic Stock Exchange in a Transitional Stage," p. 82; Mohammed Obaidullah, "Islamisation and Stock Market Efficiency," *New Horizon*, July, 1997, p. 10.

⁵¹ Husein Salamon, "Speculation in the Stock Market from the Islamic Perspective," p. 43.

in, say, two years time. To one person, this activity is an investment, as two years are long term in this reckoning of time; another person may view this as speculation, since he interprets long term to be ten years or more.⁵² Moreover, imposing a period for holding the commodities or shares before reselling them will definitely create a problem of liquidity even for genuine traders. Hussin Salamon, for instance, advanced some suggestions; however, the practicable dimensions of those suggestions might carry with them some problems. He observed that

An urgent need for cash by genuine investors for their personal spending could be met through several ways. First through various welfare funds operating within the Islamic environment such as from *zakah* (compulsory charity) *bayt al-māl* (treasury of the state) and *qard ḥasan* (welfare) fund. Second, every company could organize its own fund to cater to investors' emergency need for cash. Third, if the above ways are not available, the authority (or a special committee could be established by the authority to handle such a problem) of the alternative model is responsible to verify the genuine nature of the investors' need. If it is genuine, the investors should be allowed to liquidate their shares, while having to pay the tax.⁵³

It is worth noting that *zakah* will definitely not be used to manage market problems. Similarly, it is difficult to imagine anybody or organization that will provide *qard ḥassan* for the market without any return.

Another commentator went to the extent of saying that to curb speculation we have to look at people's intentions because to be a shareholder in an Islamic company one must have a real intention and not a virtual one (*shaklī*).⁵⁴ However, this argument is opposed by other scholars who consider the issue of intention as impracticable and moreover it is not a *sharī'ah* requirement that a person should perform a *niyyah* (religious intention) before concluding a sale contract.⁵⁵

Similarly, Aḥmad Muḥyī al-Dīn was very critical of speculation. After raising doubt about the economic benefits of speculation and hedging as means for price discovery and liquidity, Muḥyī al-Dīn maintained

⁵² See Doreen Soh, *Invest in Commodities, Gold & Currencies*, p. 14.

⁵³ Husein Salamon, "Speculation in the Stock Market from the Islamic Perspective," p. 44.

⁵⁴ See Saif al-Dīn Ibrāhīm Taj al-Dīn, *Naḥwa Namūzaj Islāmī Lisūq al-Ashum*, Journal of Research In Islamic Economics, King 'Abd al-Azīz University, Saudi Arabia, vol. 3 no. 1, 1985, King 'Abd al-Aziz University, Saudi Arabia, p. 61.

⁵⁵ See Muhammad 'Abd al-Halim Omar, "Al-Jawānib al-Shar'īyyah al-Āmmah Li al-Sharikāt al-Āmilah fi Majāl al-Awrāq al-Māliyyah," *al-Iqtisād al-Islāmī*, Dubai, no. 204, March 1998, p. 810.

that speculation has many bad economic repercussions.⁵⁶ He also argued against speculation from the legal or *sharī'ah* perspective, and it is this line of argument that will be the focus of our discussion here. He differentiated between speculation based on spot transactions and speculation based on futures contracts. Regarding the first kind of speculation, after considering the numerous advantages of the stock exchange, Muḥyī al-Dīn acknowledges the fact that there is no other way to have a viable and liquid market without having some people who are looking for price differentials in order to activate the market and to provide liquidity to the participants. However, the issue, according to Muḥyī al-Dīn, needs to be regulated.⁵⁷

Aḥmad Muḥyī al-Dīn maintains that speculation based on futures contracts where there is no physical delivery should be declared illegal because the parties have no real intention of concluding a sales contract, and the action of the parties for offsetting their transaction rather than taking physical delivery is an indication of that. Moreover, such transactions are a kind of gambling and the parties are calling it a sale just as a form of *hīlah* (legal trick). In addition, this kind of sale is similar to *bay' al-īnah*, where the parties do not intend to carry out a real sale but wish to make a loan with usury in the form of a sale. Furthermore, this kind of sale is in direct contradiction with the objective of *sharī'ah* insofar as a sale should exchange countervalues or at least one, which is not the case in the above transaction. Finally, such sales should be prohibited based on the principle of blocking the means (*sad al-dhrā'i*). Muḥyī al-Dīn singles out futures contracts as one of the main fields of speculation because traders are reselling before taking possession.⁵⁸

First of all, looking at Muḥyī al-Dīn's definition of speculation, it is clear that it is not directed precisely to speculation as it is, or even to the issue of looking for price differentials, but to the different contracts used for speculation and price differentials. Thus, he concluded by legalizing speculation if the contract is executed on the spot but making it illegal if the contract is for future execution. Therefore, it could be argued that if the legality of speculation is directly associated with the type of

⁵⁶ See Aḥmad Muḥyī al-Dīn, *Aswāq al-Awrāq al-Māliyyah wa Athāruḥā al-Inmā'iyyah fi al-Iqtisād al-Isālmī*, Dallah al-Barakah, Saudi Arabia, 1996, pp. 479–521.

⁵⁷ *Ibid.*, p. 606.

⁵⁸ For a full account of these objections, see Aḥmad Muḥyī al-Dīn, *Aswāq al-Awrāq al-Māliyyah wa Athāruḥā al-Inmā'iyyah fi al-Iqtisād al-Isālmī*, pp. 579–607.

contract used, it will be better to discuss Muḥyī al-Dīn's argument on speculation by analyzing his stand on futures contracts.

For instance, he maintains that one of the factors in futures contracts leading to speculation is that traders are reselling what they have bought before taking possession. Such an exchange is illegal in the *sharī'ah*, according to Muḥyī al-Dīn, except for the Mālikis who confine such prohibition to foodstuff. Rejecting the Mālikis opinion, Muḥyī al-Dīn argues that the evidence is general and includes everything sold before taking possession.

As it will be elaborated in the next chapter, the evidence about the issue of sale before taking possession has been the subject of differences of opinion among early scholars, where destruction of the commodity before taking of possession is possible. However, this is not the case nowadays and therefore, the maxim that the ruling of any case is associated with the presence of cause or *'illah (al-ḥukmu yadūru ma' illatihi wujūdan wa 'adaman)* will apply. On the other hand, Muḥyī al-Dīn's analogy between futures transactions and *bay' al-īnah* (selling of something to someone at a given price on credit and then buying it back from him at the same time for a lower price) carries a discrepancy. In *bay' al-īnah* the possibility of *ribā* is clear, while it is not the case in futures transactions. This is illustrated by the fact that in *bay' al-īnah* one of the parties is in need of a loan which he fails to obtain through legal means and, therefore, resorts to *bay' al-īnah* in order to get it. However, in the futures market no participant is interested in getting loans and, even if he has such an intention, it will never materialize since the futures market is not a place for raising loans. It is meant for managing business risks.

It should be noted that the present study holds the view that the excessive form of speculation must be eliminated from any possible Islamic market. However, the limited form of speculation or the issue of just looking for price differentials is necessary and cannot be eliminated if we want the Islamic market to perform its functions.

Bearing this necessity in mind, perhaps some scholars have rejected the idea that a genuine Muslim investor should keep the share he bought for a long duration, six months as suggested by some. They maintained that there is nothing wrong in trading shares for the purpose of looking for price differentials based on the principles of freedom of transaction, which do not put restrictions on the time of holding a specific commodity before reselling it, or of a minimum or maximum percentage of benefit before reselling it.

Thus, a person may buy the shares of a specific company, although he is not concerned with its overall performance, with the expectation of the actual movement of share prices. It may happen that the overall performance of the company this year may not be good but its shares may suddenly rise due to new investment opportunities concluded by the company or other internal or external factors. Thus, the investor who is looking just for price differentials may benefit, although the main shareholders of the company who are looking for its overall performance may lose due to its poor performance throughout the financial year. And the opposite scenario is also possible.⁵⁹

Similarly, the Islamic Fiqh Academy in its discussion about the *zakah* of shares differentiates between the *zakah* of shares (wherein the investor is a shareholder of the company) and the situation in which he is buying shares in order to sell whenever there is a price rise.⁶⁰ This differentiation is a kind of implicit rejection of the opinion that traders should keep the shares they have bought for at least six months or for a longer time before liquidating them, confirming, simultaneously, the legality of looking for price differentials.

On the other hand, while rejecting the idea that investors must keep their commodities for a period before liquidating them, Akram Khān says:

Some writers have suggested that to check speculation the Islamic economy should make it compulsory that people hold the investment for specified period of time before liquidating it. We think it is not only overly restrictive but also unnecessary.⁶¹

Thus, as it is rightly stated by Mohammad Akram Khān,

Speculation is a mental activity in which a person formulates his judgment about future course of the market. In every day life, most of us speculate about different economic events. Therefore, in its strictly literal sense, there is “nothing” objectionable about speculation in the Islamic framework. In fact, no law can be enforced against speculation, as *prima facie*, it involves lawful activities of buying and selling.⁶²

⁵⁹ Al-Zuāhili, *Bay' al-Ashum*, Dār al-Maktabi, Damascus, 1997, pp. 33–34; Muhammad al-Mukhtār al-Salāmi, “al-Mutajarah Bi Ashum Sharikat Gharaduhā wa Nash'atuhā Mubāh Lakinnahā Tuqrīd wa Taqtarīd Bi Fā'idah”, *Amāl al-Nadawh al-Fiqhiyyah al-Khāmisah*, Bayt al-Tamwīl al-Kuwaiti, Kuwait, (2–4 November, 1998), p. 23.

⁶⁰ Majma' al-Fiqh al-Islāmī, *Qarārāt wa Tawṣiyāt* (1985–1988), al-Dawrah al-Rābi'ah Qarār no. 3 Zakāt Ashum al-Sharikāt, pp. 61–62.

⁶¹ Muhammad Akram Khān, “Commodity Exchange and Stock Exchange in Islamic Economy,” *American Journal of Islamic Social Sciences*, vol. 5, issue. 1, 1988, p. 101.

⁶² *Ibid.*

Speculation and Financial Crises

Many commentators have tried to link the occurrence of crises with speculation. The two crises generally cited in this regard by some Muslim writers and which occurred in Muslim countries are the market crash in Kuwait in 1984 and the financial crisis in South East Asia in 1997.⁶³ We have also besides these two major crises, the crisis of the Kuala Lumpur Commodity Exchange in March 1984. Business is not successful all the time. Failure and loss are unavoidable. However, these problems may occur due to ordinary market movement as well as due to excessive speculation or due to market structure and weaker supervision.

Before addressing the claim of a link between the two crises cited above and speculation, we may refer first to the causes behind the crisis of the Kuala Lumpur Commodity Exchange in March 1984 and how a market can be rocked not because of speculation but due to other factors, such as a lack of adequate licensing, ineffective supervision, a lack of decisive management and control, or malpractices. A necessary requisite for the orderly and healthy development of any commodity futures market is the provision of proper regulations protecting the interests of investors. Such regulations should ensure that they are doing business within a system that possesses adequate measures against fraudulent or irresponsible practices, and should ensure the observance of high standards of conduct.

Thus, the above defects contributed, in one way or another, to the 1984 crisis in the Malaysian commodity market. Regarding the issue of licensing for futures dealers, brokers, and advisors, there are no proficiency qualifications spelt out in the Commodities Trading Act of 1980. Section 27 of the said act sanctions the refusal of registration of dealers and brokers who are not "fit and proper" persons, who have been convicted of criminal offences, or who are undischarged bankrupts. Thus, it seems that the criterion of competence has been put aside. There is no requisite whatsoever regarding education, training, and examination that enables the dealers and brokers to effectively represent and safeguard their clients' interests. In addition, under the 1980 regulation the

⁶³ See, Husein Salamon' paper "Speculation In the Stock Market form the Islamic Perspective", pp. 17–18; *al-Iqtisād al-Islāmī*, "al-Mudārabāt al-Ribawiyyah Warā' Azmat al-Būrṣah" (Conference report), issue no. 202, September 1997.

Commodities Trading Council was appointed to supervise the trading in commodity futures. However, the regulation of the clearinghouse fell outside the jurisdiction of the Commodities Trading Council. This was rather strange in view of the fact that the clearinghouse was supposed to operate in tandem with the exchange and was in fact an integral component of the entire commodity futures system. Moreover, there is no provision to control excessive speculation. The only provision in this regard was that the Minister could establish and fix trading and position limits. However, the government was reluctant to intervene in such a self-regulatory industry, as the thinking was that the trading floor should be allowed to be free.⁶⁴

Similarly, there was a problem of management and control. In an industry that trades on volatility and uncertainty, prolonged deliberation over management decisions is certainly detrimental to the health of the market. In the beginning, the rules and regulations were deliberately relaxed to attract investors, as is typical for any new market. As such, no position limits were imposed, which meant that the potential existed for anyone to overtrade, so as to influence price trends.

Given the above loopholes, from the latter half of 1983 the market became very volatile and by January 1984 the problem of excessive speculation was acute; but still, the KLCE did not tighten its rules even after being notified that a single trading firm was holding about sixty-eight percent of the open positions. At this juncture, the KLCE ought to have invoked Trading Rules 408 and 409, which would have enabled it, after consultation with the KLCCH, to impose trading and position limits. Instead, the market manipulation continued unchecked and was, in fact, aggravated by the lack of coordination between the KLCE and the KLCCH. The working relationship between these two institutions was strained. Both of them found it difficult to get the other to agree to some form of concerted action. Finally, many malpractices also contributed to aggravate the situation.⁶⁵ Thus, it is clear from the above case that a market may crash not because of speculation but due to other factors.

Regarding the effects of speculation in the recent economic crisis in Malaysia and around the region in 1997, currency speculation did

⁶⁴ For more detail, see Yeo Hwee Ying, "The Kuala Lumpur Commodity Exchange (KLCE) Case Study of the Crude Palm (CPO) Futures Market," pp. 229-232.

⁶⁵ Ibid.

indeed play a role in aggravating the situation. However, according to the Malaysian Institute of Economic Research there were many emerging signs that proved disturbing to the Malaysian economy even before the crisis. These signs are summarized below:

- **Economic growth above trend or potential output:** The growth of the economy has been consistently above what is deemed as its potential growth since 1991. In 1996, it was estimated that the actual GDP was about six-to-ten percent above the potential output. If an economy is to grow at a rate above its potential growth path in the longer term, it has to improve its efficiency in utilizing outputs. However, the reverse seems to have occurred in the Malaysian economy.
- **Loss of efficiency in the economy:** The presence of misallocation of resources as indicated by the growth trend of Total Factor Productivity (TFP) and the incremental capital output ratio (ICOR) computation of TFP growth over the years showed a declining trend, and the 1997 estimate of TFP was negative. The contribution of the TFP growth to overall growth in the economy correspondingly declined. Growth was instead driven primarily by capital stock accumulation.
- **Current account deficit:** The steep depreciation of the ringgit and its continued volatile exchange rate was the result of several interrelated factors. Some of these, especially the contagion effect of adverse regional economic developments, are beyond the control of policy makers. However, the deficit in the current account balance was a source of concern.
- **Excessive credit expansion especially to nonproductive sectors:** The total annual loans growth had been rising at a fast pace since 1995. The monthly total loans growth (year on year) rose to a worrisome level of close to thirty per cent in 1997 peaking at a thirty percent growth in June 1997. In March 1997, due to excessive loans extended by the banking system, the central bank imposed quantitative restrictions on the amount of loans to less productive sectors, defined to include the broad property sector, consumption credit, and loans for the purchase of stocks and shares.⁶⁶ Moreover, based on

⁶⁶ For more detail, see Mohamed Ariff and others, *Currency Turmoil and the Malaysian Economy—Genesis, Prognosis and Response*, Malaysian Institute of Economic Research, Kuala-Lumpur, 1998, pp. 2–8.

some economic analyses, it is believed that the ringgit appeared to be overvalued by some fifteen-to-twenty percent when the crisis started.⁶⁷

Besides these factors, many other factors contributed to the 1997 crisis as the Malaysian Institute of Economic Research concluded in its study that stated:

Currency speculators have no doubt contributed to the present turmoil in financial markets. This has resulted in the ringgit depreciating excessively. However, it is to be noted that speculators would not have succeeded had there been no weaknesses in the micro and macroeconomic fundamentals in the first place.⁶⁸

On the other hand, it should be noted that the speculation in the 1997 crisis was basically a currency speculation which affected the banking and other sectors of the economy.⁶⁹ However, at the beginning of the crisis, the commodity futures market in Malaysia represented by the crude palm oil futures was almost unaffected until the imposition of capital control in 1998. Turnover on the Commodity and Monetary Exchange of Malaysia's Crude Palm Oil (CPO) Futures Market in 1998 was 353,539 contracts (including Exchange of Futures for Physical-EFP), or approximately 8.84 million metric tons of crude palm oil compared with 483,651 contracts or 12.01 million metric tons in 1997, a decline of twenty-seven percent.

The average daily turnover for the first nine months of 1998 was 1,615 contracts. This, however, fell to 928 contracts per day in the last quarter as a consequence of the imposition of capital measures in September. For the entire year, average daily volume was 1,443 contracts compared to 1,958 contracts in 1997. The imposition of capital control had a negative impact on the market as most of the foreign players closed their positions. This could be seen in the total open position which fell drastically by 41.0 percent to 4,597 contracts from 7,785 in 1997.⁷⁰

⁶⁷ Ibid., p. 11.

⁶⁸ Ibid., p. 29.

⁶⁹ See Mohammad Obadyatullah, "Malaysia from Currency to Banking Crisis," *Malaysian Journal of Economic Studies*, Vol. XXXV, no. 1 & 2, Jun/ December 1998, pp. 73-94.

⁷⁰ See Commodity and Monetary Exchange of Malaysia, *Update*, "The Crude Palm Oil Futures Market Overview for 1998," Issue of January 1999, p. 1; Bank Negara, *The Central Bank and the Financial System in Malaysia-A Decade of Change*, p. 385.

Thus, it could be concluded that the recent economic crisis is the result of different weaknesses in the Malaysian economy that existed before the crisis and not just the result of a speculative attack, although speculation worsened the situation. But to put all the blame on speculation even in its restricted and regulated form is unwarranted. Moreover, the speculation of the 1997's crisis was mainly currency speculation. However, as is elaborated in the first part of the present study there is no possibility of a futures currency market in Islamic finance or the possibility of using currency as a commodity for short investment. Even the simple forward currency contract is unacceptable in Islamic finance, although several Islamically acceptable tools have been proposed at the beginning of this study in order to meet the need and demand of genuine traders. Hence, allowing traders to invest or speculate in currency forward, futures and swap contracts could be considered as another weakness in the Malaysian financial system, which contributed to the crisis if it is judged from an Islamic point of view.

Regarding the stock market crash in Kuwait in 1984, there are different causes that can be mentioned. Although the preliminary symptoms of the problem were evident as early as 1976, the crash itself occurred in 1984. The direct causes of the crisis can be summarized as follows:

1. The absence of active regulatory bodies, which could supervise the market activities and control the implementation of its regulations. Moreover, the central bank did not play its role effectively regarding monetary policy.
2. The absence of transparency and reliable information about the status of the listed companies due to the ineffective role of the accounting and auditing agencies. This situation was contrary to the principle that there is no right investment without right information.
3. Weaknesses in the brokerage industry regulation, which resulted in inconsistency in prices. Moreover, there were no specific provisions about the role of brokers, thus allowing a broker to trade for himself or for his client as he wished, since there was no regulation, no supervision, and no association of brokers.
4. Trade in the market was limited to shares only with no other alternative to absorb liquidity. The lack of regulation prompted many people to manipulate prices and be involved in excessive speculation.
5. There was no proper system of clearance, which would have guaranteed the rights of all parties.

6. The expansion of futures trading with a total absence of regulation of such transactions also worsened the situation.⁷¹

Thus, it is clear that the crisis was not the result of speculation, but rather of structural and regulatory weaknesses in the Kuwaiti Exchange, its brokerage industry, its clearing system, and its futures industry management.

Arbitrage and Speculation

Commodity arbitrage is the purchase of a commodity in one market and the simultaneous sale of the identical commodity in another market (having different prices) with the goal of profiting from the temporary differences in prices in different markets.⁷²

Distortion in price often results from factors that are not readily quantifiable. For example, the opinions of traders having different information at hand, or different interpretations of the same information may result in price distortion. More commonly, such distortions occur when there is a time difference between the trading hours of two or more markets. If, for example, coffee closed at a simplified price of £2,300 per ton in the New York market and during the first few hours of the morning session in London the following day, and before the reopening of the New York market, the same price rose to £2,350 for whatever reason, an arbitrage opportunity would be possible immediately after New York market opens. By selling in London at £2,350 per ton and simultaneously purchasing in New York for £2,300, a paper profit of £50 per ton would be secured. To realize the profit the positions need to be reversed and offset against each other. The offsets are executed in each market when prices move back into alignment. If, after the arbitrage trade had been placed, the price settled at £2,325, the London 'short' position would yield a profit of £25 as would the closure of the New York 'long' position.⁷³

⁷¹ See Samir Abd al-Ghani Mahmud, "al-'Abā' al-Qawmiyyah Li Azmat al-'Awraq al-Māliyyah bi Dawlat al-Kuwait," *Majallat al-'Ulūm al-Ijtīmā'iyyah* (Jami'at al-Kuwait), no. 14, vol. 1, 1986, pp. 13–34.

⁷² David County and Eric C. Betteheim, *An Introduction Guide to the Commodity Futures Markets*, London, Butterworths, 1986, p. 86.

⁷³ *Ibid.*, pp. 86–87.

In other words, it is the simultaneous purchase and sale of the same commodity at a price which guarantees and assures profit. The delivery of the commodity and realization of the profit may be made in the future.⁷⁴

Despite the fact that arbitrage is very similar to speculation, many Muslim scholars have maintained that arbitrage is legal. Illustrating the above case, Akram Khān reports the following example. Suppose a wholesale egg dealer in Lahore notes that the price of eggs in Karachi is so high that if he buys eggs in Lahore and ships them to Karachi, he will still make a profit. He would buy eggs in Lahore and would simultaneously sell them to some Karachi merchants. The deal in Lahore would take place in the spot market. The Karachi deal would take place in due course of time when the eggs are delivered in Karachi and the money is received. The arbitrageurs make money out of the small price differentials in the two markets. The economic role of the arbitrageurs is that they stabilize the market in different trading centers.⁷⁵

For another example of arbitrage, suppose a stock is bought for \$5.00 on the Paris Bourse (stock exchange) and simultaneously sold for \$5.25 on the New York Stock Exchange. It should be noted that an arbitrageur must usually carry an inventory because all his sales cannot be made simultaneously with purchases. The arbitrageur, therefore, holds a speculative position and he cannot be easily distinguished from a speculator.

Commenting on the above example, Manan maintains that while the activity of the simple arbitrageur can be compared with a trader buying in one market and selling in another, depending on the elasticity of demand, it may have relative validity in *shari'ah*. But in actual practice, the arbitrageur can hardly be distinguished from the speculator.⁷⁶

⁷⁴ Muhamad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," p. 97.

⁷⁵ *Ibid.*, 97.

⁷⁶ See M.A. Mannan, "An Appraisal of Existing Financial Instruments and Market Operation from an Islamic Perspective," *Developing a System of Financial Instruments* (proceedings of a seminar held in Kuala Lumpur, Malaysia, 28 April–5 May 1986), edited by Mohamed Ariff and M.A. Mannan, Islamic Research and Training Institute Islamic Development Bank, Jeddah, Saudi Arabia, p. 89.

Margin Trading and Speculation

One of the most advanced means of restricting speculation by Muslim scholars in the stock market, in particular, is to ban the use of margin trading. It should be noted that the concept of margin trading in the futures market differs from that in stock trading. It is, in the context of futures trading, the amount of money deposited by every holder of a long or short contract with his or her brokerage house to guarantee the performance of the contract.⁷⁷ In the context of stock trading, it refers to the amount of ownership the investor must have in each share he purchases. The remaining amount is covered by a loan from the broker. Interest is paid for such a loan and the stock is held by the broker as collateral on that loan.⁷⁸ The prevalent use of the margin in stock markets is opposed by Muslim scholars on different grounds.

Addressing the issue, El-Gāri said:

The fact that borrowing with interest is involved in such transactions clearly makes it void, since interest is *ribā*. But what if borrowing with interest is not included? The transaction will remain unacceptable for two reasons: first, it includes a loan that produces an obvious benefit to the lender (albeit with no interest) that is holding the stock and using it in other profitable transactions. The rule in the *sharī'ah* is that every loan, which will benefit the lender, is *ribā*. Second, the transaction includes two contracts. According to the rule in the *sharī'ah* combined contracts void each other.⁷⁹

It should be noted that futures margins differ from stock margin in both concept and method of computation. Stock margins constitute a partial payment to the brokerage house. The remainder of the price is the amount of debt owed to the brokerage house on which interest is charged. Futures margins, on the other hand, are actually good-faith deposits to protect a broker against risk in the event of adverse price moves in the interim period between the establishment of a position and its liquidation either by delivery or by offset. Stock margins typically fluctuate in a range of fifty to ninety percent, although both limits of this range have been exceeded for brief periods. Futures margins

⁷⁷ New York Institute of Finance, "Futures: A Personal Seminar," New York 1989, p. 19.

⁷⁸ Mohammad El-Gāri, "Stock Exchange Transactions: *sharī'ah* Viewpoints," p. 168.

⁷⁹ Ibid.

are based on fixed minimums per unit such as ounces, pounds, tons, or face values of financial instruments established by the exchanges, but an individual broker may require a large amount if he believes the minimum involves undue risks for themselves or their clients. Moreover it should be noted that futures prices frequently remain in quite narrow ranges for long periods and are not more volatile than typical securities prices in a similar price range.⁸⁰

Thus, the three reservations raised by Muslim scholars regarding the use of margins in securities trading, namely, the issue of interest rates, the use of margins involving loans that benefit the lender, and the margin as a kind of combined contract, are not present in futures commodity trading.

⁸⁰ Richard J. Teweles, Frank J. Jones, *The Futures Game: Who Wins? Who Loses? And Why*, ed. Ben Warwick, McGraw-Hill, New York, pp. 21–22.

CHAPTER SIX

SALE PRIOR TO TAKING POSSESSION, SALE OF DEBT AND FUTURES CONTRACT

One of the objections to the futures contract is that it involves sale prior to taking possession. The majority of scholars of the different schools of Islamic law held that sale prior to taking possession is illegal. Moreover, most contemporary Muslim scholars have followed in the footsteps of the majority of early scholars by stressing that sale prior to taking possession is illegal, overlooking the difference of opinions on the issue, on one the hand, and not analyzing the changing circumstances and their relevance to the issue on the other. Thus, the two prominent *Fiqh* Academies, namely the Jeddah- and Makkah-based, passed negative judgments on futures contracts and one of their main arguments is that it involves sale prior to taking possession.¹

Juristic Debate over Sale prior to Taking Possession

The juristic debate over the issue is based on several *aḥādīth* reported from the Prophet (PBUH) stating that “He who buys foodstuff should not resell it until he receives it.”² It is also reported that the Prophet said, “He who buys foodstuff should not resell it until he is satisfied with its measurement.”³ It is also reported that Ibn ‘Umar said: “At the time of the Prophet (PBUH) we used to trade on foodstuff. Then, the Prophet (PBUH) sent to us a person to order us not to resell it unless we move it to another place.” It was also reported that Ḥakīm Ibn Ḥizām asked the Prophet (PBUH) saying, “I am making different deals, what is legal for me to do and what is not?” Then the Prophet (PBUH) advised him

¹ See Al-Majma‘ al-Fiqhī al-Islāmī li-Rābiṭat al-‘Ālam al-Islāmī, *Qarārāt Majlis al-Majma‘ al-Fiqhī, al-Islāmī*, seventh session, from 11–16 Rabi‘ al-Ākhir, 1404 “Sūq al-‘Awraq al-Māliyyah wa al-Badā’i (al-Burṣah)” pp. 120–124; Islamic Fiqh Academy’s resolution no. 64/17 *Majallat Majma‘ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 398.

² *Saḥīḥ Muslim*, vol. 10, p. 169.

³ See *Saḥīḥ al-Bukhārī with Fath al-Bārī*, Book of Sale, vol. 4, pp. 349–350, *ḥadīth* no. 1525 and the following *aḥādīth*.

saying, “If you buy something do not resell it until you receive it.”⁴ It is also reported by Zaid Ibn Thābit that the Prophet (PBUH) prohibited the sale of commodities which were bought from other traders until the commodities were relocated by the buyers to their own places.”⁵ From these *aḥādīth*, Ibn ‘Abbās concluded saying “I think it applies to other things as well.”⁶

This opinion has also been followed by the Shāf‘ī jurists maintaining that it is illegal to resell anything before receiving it or taking possession of it, whether it is foodstuff or otherwise. They based their opinion on the literal meaning of the above *aḥādīth*. In addition, they argue that since the commodity is not transferred to the buyer, the seller will still be liable for any destruction or loss that may affect the buyer. Moreover, if the buyer resells it to a third person, and the third person to a fourth, it would be a chain of liability, which might be the source of *gharar*.⁷

The second opinion is the Ḥanafī view. They maintain that it is illegal to resell anything before receiving it or taking possession of it unless it is a real property. They argue that reselling anything before receiving it is a kind of *gharar*, since the commodity bought may perish or be destroyed before the buyer receives it and as a result the seller may not be able to deliver it to the new buyer. However, such a risk or *gharar* is very remote in the case of real property. Hence, it should be allowed. Thus, according to the Ḥanafīs, the prohibition of reselling before taking possession is based on the fear of destruction. It is also argued that such a sale will lead to a chain of liability.⁸

The third stand is that of the Mālikīs and some Ḥanbalīs. They maintain that the above ruling should be restricted to foodstuff only. They argue that only the *aḥādīth* that mention foodstuff are qualified (*muqāyyadah*), while the other *aḥādīth* are general (*muṭlaqah*). Moreover, the above *aḥādīth* are specific about foodstuff while the other *aḥādīth* are general. Therefore, as it is the rule in Islamic jurisprudence, in such a case the specific must prevail.⁹

⁴ *Musnad Imām Aḥmad*, vol. 3, p. 302.

⁵ *Saḥīḥ al-Bukhārī*, Dār al-Qalam, Damascus, 1981, vol. 3, p. 750; *Saḥīḥ Mulim with al-Nawawī*, vol. 10, p. 168.

⁶ See *Saḥīḥ al-Bukhārī with Faṭḥ al-Bārī*, Book of Sale, vol. 4, pp. 349–350.

⁷ Al-Nawawī, *al-Majmū Sharḥ al-Muhadhdhab*, vol. 9, pp. 264–271.

⁸ See al-Kasānī, *Badāi’ al-Sanāi*, vol. 4, pp. 394–396.

⁹ Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 142; Ibn Juzai, *al-Qawānīn al-Fiqhiyyah*, p. 341; al-Bājī, *al-Muntaqā*, vol. 4, p. 283.

A fourth opinion is reported from Ata Ibn Abī Rabāh and ‘Uthmān al-Batti, maintaining that it is legal to sell anything before taking possession. However, this opinion has been rejected by other jurists on the grounds that it totally ignores the previous *aḥādīth* and it is possible that these scholars may not have come across these *aḥādīth*. The last opinion is that of Ibn Ḥazm, who maintains that the prohibition in those *aḥādīth* should be limited to wheat. This is because the word *ta‘ām* that occurs in the *ḥadīth* means wheat and nothing else.¹⁰

The positions of Islamic financial institutions and some *sharī‘ah* boards are also divergent. Thus, it was decided in the al-Barakah sixth conference, *fatwā* no. 14, that the prohibition of sale prior to taking possession is confined to foodstuff.¹¹ Similarly, the *sharī‘ah* board of al-bank Islāmī al-Sudānī preferred the Mālikīs’ opinion and allowed sale prior to taking possession unless it is foodstuff.¹² The *sharī‘ah* board of the Kuwait Finance House has taken a similar stand in one of its *fatwā*.¹³

However, the issue has been the focus of debate between the participants in the Islamic Fiqh Academy session on *al-qabḍ wa ṣuwaruhu al-mustajiddah* (taking possession and its modern aspects). Some of the participants, such as al-Qaraḍāghī, Nazīh Ḥammād, Mukhtār al-Salāmī, Muahammad Nabīl Ghunaim, Omar Jah and others, consider the prohibition to be confined to foodstuff, arguing that there is no *gharar* in reselling before taking possession. People around the world are doing so without any dispute resulting from such *gharar*, while in principle *gharar* is that risk which will lead to a dispute. On the other hand, other scholars like al-Ḍarīr al-Zuhailī, ‘Ali al-Sālūs and others maintain that it includes everything and therefore, it should not be allowed.¹⁴

From the above it seems that the third opinion, namely that the prohibition of reselling before taking possession is limited to foodstuff, is the preferable stand due to the strength of its argument and its suitability to prevailing market practices, especially if we refer to the *ḥadīth* reported by al-Bukhārī in which he commented by saying, What is prohibited by the Prophet (PBUH) until the taking of possession takes place is

¹⁰ Ibn Ḥazm, *al-Muḥallā*, vol. 9, p. 292.

¹¹ *al-Fatāwā al-Iqtiṣādiyyah*, p. 37.

¹² al-Bank al-Islāmī al-Sudānī, *Fatāwā Ha’iat al-Raqābah al-Sharīyyah, Qism al-Amwāl*, Idārat al-Tawjīh al-Sharī’ wa al-Buhūth, pp. 14–17.

¹³ ‘Abd al-Sattār ‘Ali Qaṭṭan, *Bay’ al-Bidā’a Qabl Ḥiyāzitiḥā*, Bayt al-Tamwīl al-Kuwaiti, n.d., pp. 17–19.

¹⁴ For more details about this discussion, see *Majallat Majma’ al-Fiqh al-Islāmī*, (Discussion about *al-Qabḍ wa Ṣuwarhī al-Mustajiddah*), no. 6, vol. 2, pp. 739–767.

foodstuff.”¹⁵ This expression shows that the prohibition is just limited to foodstuff. Moreover, the claim is made that, by reselling before taking possession, the seller is profiting from something for which he is not bearing the liability of loss since the liability of the sold commodity is still with the first owner. However, the proponents of the preferred opinion maintain that the liability will be transferred to the buyer and there is nothing illegal in having a chain of liability.

Furthermore, Ibn Qayyim in his defense of the legality of sale prior to taking possession brought up a number of cases in which there is a sale prior to taking possession and they are accepted as legal, even by those who oppose the legality of the sale prior to taking possession. This includes the legality of a person’s selling his share in inheritance before taking possession or what he got through a will or bequest and the right for a woman to sell her dowry.¹⁶ This shows that the position that prohibits any sale before taking possession is not consistent.

Based on the above argument, it could be said that taking possession of something before reselling it is not a condition in the commodities futures market involving nonfoodstuff products, such as cotton, rubber, tin, metal platinum, aluminum, and especially oil and its derivatives. However, foodstuff commodities would be included based on the strict and literal application of the above opinion.

However, one may ask is the prohibition of reselling foodstuff before taking possession based on rationality (*taʿlīl*) or is it a dogmatic matter (*taʿabbudi*)? If its basis is rational, such as the possibility of it being destroyed or perishing, as is advanced by the Ḥanafīs, Shāfʿīs¹⁷ and Ḥanbalīs,¹⁸ it could be said that this possibility may not occur nowadays in some foodstuff commodities, which can be preserved for a long time due to technological advancements. Moreover, the modern futures market has never witnessed a dispute based on such an issue due to the modern mechanisms in place.

Similarly, if we consider the Mālikīs’ opinion which allows the sale of foodstuff before taking possession, in lump sum (*juzāf*) without weight or measure, it could be argued that the *ʿillah* or the cause of

¹⁵ See *Ṣaḥīḥ al-Bukhārī with Faṭḥ al-Bārī*, Book of Sale, vol. 4, pp. 349–350, *ḥadīth* no. 1525, and the following.

¹⁶ For a full report of these cases, see Ibn Qayyim, *Sharḥ Sunan Abi Dāʿūd with ʿAwn al-Maʿbūd*, vol. 9, pp. 386–7.

¹⁷ al-Shirāzī, *al-Muḥadḍḥab*, vol. 4, p. 280.

¹⁸ Ibn Qudāmah, *al-Muḥḥnī*, vol. 4, p. 114.

the prohibition of reselling foodstuff before taking possession is not because the commodity is foodstuff, as maintained by some scholars¹⁹ who argue that foodstuff has a special position in the *sharī'ah* and because monopoly in foodstuff was strictly prohibited. Moreover, the selling of foodstuff is also associated with currency in a specific ruling regarding the exchange of *ribawī* (involving *riba*) items, which is not the case with other items. Therefore, these scholars argue that it is not feasible to ignore the command in the *ahādīth* regarding sale before taking possession involving foodstuff.

Some Mālikīs maintain that the *'illah* here is the possibility of *ribā* and therefore, the sale of foodstuff should be prohibited on the basis of blocking the means (*sad al-dharā'ī'*). Thus, a person may sell wheat to another person and then buy it from him with the intention of obtaining the cash while the action of buying and selling is just a trick or *hīlah*.²⁰ A similar interpretation is also reported from Zaid ibn Thabit and Abū Hurairah. Al-Shawkānī considers it as the best kind of *ta'līl* or rationalization because these companions are the best persons to know about the meaning and objective of the Prophet's *ahādīth*.²¹

It seems that the possibility of *ribā* might be obtained if the buyer resells the commodity to the seller himself and this will be a kind of *bay' al-'inah*. However, if he is selling it to a third person there is no possibility of *ribā* and, therefore, it should not be prohibited. More importantly, the objective of traders in the futures market is not to get loans through the exchange of commodities but rather to manage their risks. Hence, there is no possibility of *ribā* in the sale prior to taking possession as it is practiced in the commodity futures market.

Another argument advanced by the Mālikīs is that the *sharī'ah* has a purpose in disallowing the sale of foodstuff before taking possession. The purpose is to make foodstuffs always visible and apparent to people. This will benefit many people, such as the carrier and the measurer who may lose their jobs if commodities are traded before being taken into possession. Moreover, its continuous presence might be a source of psychological comfort to some people especially the poor in time

¹⁹ See al-Qarāfī, *al-Furūq*, vol. 3, pp. 281–282; al-Qaradāghī, “al-Qabḍ: Ṣuwaruhu wa bi Khāssatin al-Mustajiddah minhā wa Ahkamuhā,” *Majallat Majma' al-Fiqh al-Islāmī*, 1990, no. 6, vol. pp. 568–572.

²⁰ See, Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 144; al-Bājī, *al-Muntaqā*, vol. 4, p. 280.

²¹ al-Shawkānī, *Nayl al-Awtār*, vol. 5, p. 169.

of hardship. Thus, by allowing it to be sold without taking possession, traders will exchange it without making it available to the public and the above objective will be undermined.²²

Yet, even this argument seems to be of little effect in the socio-economic structure of modern society. On the one hand, some contemporary scholars have maintained that buying before taking possession will lead to an increase of the price of the commodity sold which, as a result, will burden the consumer.²³ However, this opinion is opposed by other scholars such as Majd al-Dīn ‘Azzām who did not see any necessary link between the sale before taking possession and the increase in price of the commodity.²⁴ Similarly, Kamālī maintained that ‘Azzām’s analysis is correct and it is merely presumptuous to say that every seller in the series will make a profit and even if so, the settlement price that is paid upon delivery, assuming that delivery does occur, is normally a predetermined price that has been agreed on between the buyer and the seller in the first link. If delivery takes place upon maturity, it is basically this price.²⁵

The Meaning of Ta‘ām

A certain debate has arisen about the concept of *ta‘ām* (foodstuff) in the above issue. Some maintain that *ta‘ām* is confined only to wheat as Ibn Manzūr reports from ‘ahl al-Ḥijāz, while others have limited it to dates. Ibn al-Athīr, on the other hand, maintains that it includes everything that could be considered as a foodstuff of subsistence (*yuqtātu bihi*),²⁶ while the Mālikīs, for instance, upheld that it is what falls under *zakah*.²⁷ Based on the above, it could be said that many of the commodities traded in the futures market nowadays, although they are foodstuff, are not basic food of subsistence, such as sugar, coffee, and similar products and,

²² al-Dasughī, *al-Sharḥ al-Kabīr*, vol. 3, p. 131.

²³ See Al-Ḍarīr, “al-salam wa tatbiqātuhū al-Mu‘āshirah,” *Majallat Majma‘ al-Fiqh al-Islāmī*, 1996, no. 9, vol. 1 p. 402; Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, p. 534.

²⁴ Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, p. 535.

²⁵ Kamālī, “Islamic Commercial Law: An Analysis of Futures,” p. 207.

²⁶ For elaboration on the issue, see Ibn Ḥajar, *Fathḥ al-Bāri*, vol. 3, pp. 373–5.

²⁷ See al-Bājī, *al-Muntaqā*, vol. 4, p. 280; Mahmūd Shammām, *Majallat Majma‘ al-fiqh al-Islāmī*, no. 6, vol. 2, 1990, p. 920.

therefore, could be traded in an Islamic futures market without being affected by the issue of selling *ta'ām* before taking possession, and the concept of *ta'ām* will be confined to food of subsistence such as wheat, barley, rice, and other similar products. However, some others maintain that *ta'ām* here is general to any edible thing including fruit.

Salam and the Futures Contracts

On the other hand, since the permissibility of a futures market could be based on the conventional forward contract or on *salam* as is mentioned above, the legality of selling the subject matter of *salam* before taking possession of it needs to be briefly addressed. Even though the issue is closely related to the general issue of reselling before taking possession discussed above, the juristic debate over the matter is somehow different due to the interpretation of a specific *ḥadīth* on the sale of the subject matter of *salam* before receiving it and the nature of *salam* as an independent type of sale. Thus, the majority²⁸ maintains that it is illegal to resell the substance in *salam* before taking possession, relying on the *ḥadīth* of the Prophet (PBUH), "Whoever makes *salam* shall not exchange it before taking possession."²⁹ They argue that in this *ḥadīth* it is clear that the buyer should not exchange the material of *salam* with the seller or with another person before taking possession. However, this is a weak *ḥadīth* according to Ibn Ḥajar.³⁰ Therefore, it could not be the basis for any ruling.

Ibn Taymiyyah and his disciple Ibn Qayyim maintained that there is no legal problem in exchanging the subject of *salam* before taking possession, but if it is sold to the seller himself it should be at the same price or less, but not more. However, if it is sold to a third party it could be at the same price or more or less. Moreover, Ibn 'Abbās has the same opinion as Imām Aḥmad in one of his opinions. More important, this is also the Mālikī stand. They have also maintained the distinction they have drawn between foodstuff and other products.³¹ The contemporary

²⁸ Ibn 'Abidin, *Rad al-Muhtār*, vol. 4; p. 209; al-Buḥūti, *Kashshāf al-Qinā'*, vol. 3, p. 293; al-Kāsānī, *Badāi al-Sanāi*, vol. 5, p. 214; Ibn Qudāmah, *al-Mughnī*, vol. 4, p. 334.

²⁹ Abū Dā'ūd, *Sunan Abū Dawūd*, Matbat Muṣṭaphā al-Halābī, 1952, vol. 2, p. 247; Ibn Mājah *Sunan Ibn Mājah*, vol. 7, p. 66.

³⁰ However, the *ḥadīth* is reported to be weak. See Ibn Ḥajar, *Talkhīs al-Ḥabīr fi Takhrīj Aḥādīth al-Rūfi' al-Kabīr*, Sharikat al-Tibāa al-Fanniyyah, Egypt, vol. 3, p. 225.

³¹ Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 231.

position of Muslim scholars is also divergent. Thus, Nazīh Ḥammād maintained that it is legal to sell *salam* before taking possession as is maintained by Ibn Taymiyyah and Ibn Qayyim because there is no text from the Qurʾān and sunnah, *ijmāʿ* or *qiyās*, to prohibit that but, on the contrary, the texts as well as the *qiyās* convey its legality.³² This stand has also been backed by al-Qaradāghī,³³ al-Zuhailī,³⁴ Jāsim ʿAli Sālim,³⁵ Hāshim Kamālī,³⁶ Sāmi Ḥammod,³⁷ Majd al-Dīn ʿAzzām.³⁸ On the other hand, Siddīq al-Ḍarīr, ʿAjil Jāsim al-Nashmī³⁹ and others maintained that it is illegal to resell anything before taking possession.

A partial solution to the above problem lies in the parallel *salam* or *al-salam al-muwāzi*. It is the conclusion of a *salam* contract by the first buyer in a previous contract of *salam* as a seller to sell a similar commodity to a third person without any legal relation between the two contracts. In other words, after buying goods of a certain description from a seller and paying the full price, the seller is due to deliver in that contract, and the buyer in a separate and formally unconnected *salam* contract sells goods of exactly the same description and for the same due date to a third party, receiving full advance payment from that buyer.

Despite the fact that the idea of the parallel *salam* was discussed by some early scholars, such as Ibn Qudāmah⁴⁰ and some Shīʿah scholars,⁴¹ some contemporary scholars contended that the idea of parallel *salam*, although it did not violate the principle of getting benefit without incurring liability involving *gharar*, is just a trick or *ḥilah* to *ribā*. It cannot be immune from the idea of *ribā*, especially if it has been taken as a method of trade. Moreover, it could also be a means of burdening the consumer.⁴² However, this opinion did not receive great support since the

³² *Majallat Majmaʿ al-Fiqh al-Islāmī*, no. 9, vol. 1, pp. 628–629.

³³ *Ibid.*, p. 649.

³⁴ *Ibid.*, p. 652.

³⁵ *Ibid.*, p. 654.

³⁶ *Ibid. Islamic Commercial Law: An Analysis of Futures*, p. 656.

³⁷ Bayt al-Tamwīl al-Kuwaiti, *al-Fatāwā al-Sharʿiyyah fī al-Masāʾil al-Iqtisādiyyah*, p. 526.

³⁸ *Ibid.*, p. 532.

³⁹ *Ibid.*, p. 643.

⁴⁰ Ibn Qudamah, *al-Mughni*, vol. 4, p. 350.

⁴¹ Hasan al-Jawāhiri, “al-Salam wa Tatbiqātuḥu al-Muʿāsharah,” *Majallat Majmaʿ al-Fiqh al-Islāmī*, 1996, no. 9, vol. 1, p. 514.

⁴² Siddīq al-Ḍarīr, “al-Shurūt al-Sharʿiyyah li Sihḥat Bayʿ al-Salam,” *al-Iqtisād al-Islāmī*, no. 171, 1995, p. 15; Siddīq al-Ḍarīr, “al-Shurūt al-Sharʿiyyah li Sihḥat Bayʿ al-Salam,” *al-Iqtisād al-Islāmī*, 1996, no. 9, vol. 1, p. 407.

majority upheld the legality of the parallel *salam*. Thus, the majority of the participants in the Islamic Fiqh Academy's discussion on *salam* such as Nazih Hammād,⁴³ 'Ali al-Qaradāghī,⁴⁴ Hasan al-Jawāhiri,⁴⁵ 'Abd al Sattār Abū Ghuddah,⁴⁶ and Wahbah al-Zuhailī approved its legality.⁴⁷

It should be noted that the need for parallel *salam* is not just to build an Islamically acceptable futures exchange but also to facilitate business transactions for Muslim investors trading outside the organized market. Futures trading is not necessarily done through an organized futures exchange. It could be done over the counter.

Suppose a wholesaler contacts a palm oil refining company for the delivery of 1000 tons of palm oil to be delivered six months later for RM 100 per ton. He will pay the price at the conclusion of the contract as it is the condition according to the majority of Muslim scholars in a *salam* contract or after three days or more according to the practice followed by the Mālikīs and supported by some contemporary scholars. Immediately he concludes several parallel *salam* contracts with a number of palm oil retailers to deliver a similar quantity of palm oil at the same time as the first contract for RM 110 per ton. Thus, there is no formal relation between the first *salam* contract and the following parallel *salam* contract but it allows this businessman to manage his business.

Parallel Salam and the Futures Market

To foresee the possibility of using parallel *salam* to build an Islamic futures market, let us examine the following two proposals. The first proposal is suggested by Fahim Khān. Suppose in June, A offers for sale 1000 bushels of rice to be delivered in December at RM 10 per bushel. B accepts the offer and pays A RM 10,000 for the 1000 bushels as stipulated by the conditions in the *salam* contract. However, some time later B finds a good opportunity in another trade but he finds his money blocked in the *salam* contract. He enters into a parallel *salam* contract with X to sell 200 bushels of wheat to be delivered in December at the price of RM 10.50 per bushel and receives from X RM 2,100.

⁴³ *Majallat Majma' al-Fiqh al-Islāmī*, (discussion on salam), 1996, no. 9, vol. 1, p. 628.

⁴⁴ *Ibid.*, p. 649.

⁴⁵ *Ibid.*, p. 640.

⁴⁶ *Ibid.*, p. 645.

⁴⁷ *Ibid.*, p. 651.

B finds another opportunity and offers to sell 800 bushels in December at the price of RM 11.00 per bushel under *salam* contract. C, a trader, agrees to purchase 600 bushels and pays RM 6600 to B while Y, a small saver, agrees to purchase 100 bushels and pays RM 1100 to B. Thus, in this situation there is a primary market where A and B are original traders. This trade has generated a secondary market where B is the seller and X, Y, Z are purchasers.

In December, if X and Y do not want to receive the deliveries, they may offer to sell off a number of bushels equivalent to what they purchased in their futures contract. They may offer the price of RM 11.20, as the market price is RM11.50 in order to get rid of the stock. It is possible that to deliver and sell in the cash market. C and D may accept this offer and pay to X, Y, Z respectively these amounts. B will receive the delivery from A and will make delivery to X, Y, Z and C. On the other hand, X, Y and Z receive their deliveries and deliver them to C and D. Meanwhile C and D sell the product in the spot market or keep it for their own use.⁴⁸

To further elaborate on his plan of a futures market based on *salam*, Fahīm Khān proposed that a clearing house may facilitate the above chain of transactions. Thus, for instance, A will make delivery to B using the clearinghouse as an intermediary. After taking delivery, B sells and makes delivery to X, Y and C through the clearinghouse. X and Y receive the deliveries from the clearinghouse and make delivery to C and D. C and D will either receive delivery from the clearinghouse or will sell it in the spot market. Since C and D are selling in the spot market, they can even sell their documents received from the clearinghouse and their buyers could receive their delivery from the clearinghouse.⁴⁹

Another proposal for a *salam*-based futures contract was put forward by Vogel and Hayes. Although this proposal is similar to some extent to the above proposal, it contains some positive additions. It comprises different steps, which are summarized below.

The first step is that such a market would be managed through a kind of special purpose fund, *muḍārabah* or a subsidiary of an Islamic bank, by establishing a *muḍārabah* fund to act as broker for one or more particularly fungible commodities. Suppose a fund is established to buy and sell raw cotton, and enters into a *salam* contract with a large cotton

⁴⁸ See, Fahīm Khān, *Islamic Futures and their Market*, pp. 58–59.

⁴⁹ *Ibid.*

producer for a million bales of cotton for delivery in six months. The fund has already entered into different parallel *salam* contracts in which it sells cotton under *salam* contract. The fund's profits will come from the difference between the wholesale price and the retail price at which it is bought and the retail price at which it is sold. These contracts are totally independent from each other.

The second step toward a viable market is for the fund to make a market in the retail *salam* contract, publishing "bid and asked" prices for entering into contracts as either buyer or seller. If a cotton user purchases a *salam* contract but thinks better of it, he can come to the fund and sell a *salam* contract for the amount of cotton he is long on at a price which the fund deems appropriate at that point in time, regardless of whether the fund has a counterparty lined up. In the opposite situation, if a cotton producer had sold a *salam* contract for his cotton crop several months earlier, locking himself into what he believed would be a premium price but then the price goes up further and he is convinced that the price will go up even further, he may approach the fund to purchase cotton similar to his first contract.⁵⁰

However, it should be noted that if the fund enters into contracts as principal, rather than confining itself to merely brokering the participants in the market, there is a possibility that the fund may have in some instances a net position, which is not in balance. Therefore, the fund needs a larger capital base than if its task is limited to just executing simultaneous and equal parallel *salam*. The fund brokers deal between customers and facilitate such deals by guaranteeing the performance of both parties. Such credit enhancement enables the parties to transact readily and anonymously, with a net benefit to the parties on a risk adjustment basis. The fund can guarantee the parties' obligation through the charging of administrative costs by doing so and by recouping its costs from separate sources, such as license fees, service fees, etc. *Salam* sellers can give a pledge or *rahan* for their performance, similar to a margin in conventional futures contracts. A buyer in one *salam* contract can use his investment in that contract as a pledge to secure his position as a seller in another.⁵¹

⁵⁰ Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, pp. 251–252.

⁵¹ *Ibid.*

It should be noted that although the *salam*-based futures contract may serve some of the benefits of a conventional futures contract, there are some major differences between the two concepts, such as the fact that the price in *salam* must be paid at the conclusion of the writing of the contract, as is asserted by the majority, while in the forward contract the price is postponed until the time of the delivery of the commodity. Second, in a *salam*-based futures market, the actual transfer of the commodity traded must pass from one party to another through the chain of parallel *salam*s until it reaches the final buyer. But a fund could arrange for this transfer to be done through a formal mechanism such as warehouse receipt.

On the other hand, the whole issue of taking possession before reselling might be largely simplified, with regard to futures trading through an exchange, if we consider the concept of taking possession in light of the prevailing custom in futures markets nowadays. It is generally agreed that the concept of *qabḍ* or taking possession could be *ḥaqīqī* (real) or *ḥukmī*. In the *ḥaqīqī* form, the physical commodity is transferred from the seller to the buyer while in the *ḥukmī* there is no physical delivery but through any means that could be considered as a form of taking possession.

Thus, the taking possession of the document of a specific commodity recognized by market participants as legal tender showing the transfer of ownership from one person to another is generally accepted by Islamic financial institutions as a kind of taking possession (*ḥukmī*), although the physical commodity is not transferred.⁵² Similarly, the taking of possession of companies' shares is done through the transfer of paper documents and not through physical transfer and it is accepted by many scholars as a legal transfer of ownership and a *ḥukmī* taking of possession, although some others have their reservations.⁵³ Moreover, the taking of possession of currency exchange between different banks is done just through account records or *al-qabḍ al-ḥisābī*, which is definitely not a real or physical kind of taking possession, but it is accepted by contemporary Muslims as a form of taking possession.⁵⁴

Therefore, it could be argued that although the underlying asset in futures commodities markets is a physical commodity, the futures mar-

⁵² See 'Abd al-Sattār 'Ali Qaṭṭan, *Bay' al-Bidā' Qabl Ḥiyāzithā*, Bayt al-Tamwīl al-Kuwaiti, n.d., pp. 18–19.

⁵³ See Al-Zuahili, *Bay' al-Ashum*, Dār al-Maktabī, Damascus, 1997, pp. 39–41.

⁵⁴ See *Majallat Majma' al-Fiqh al-Islamī*, no. 7, and vol. 2, pp. 747–748.

ket is a special kind of market where it is internationally recognized that the taking of possession will not occur through the physical transfer of commodities but rather through the transfer of documents confirming the transfer of ownership and liability from the seller to the buyer after the contract is registered by the clearing house. Therefore, by analogy to the above cited cases, it seems that the registration of the contract by the clearing house and the transfer of documents between the seller and the buyer in the commodity market is in fact taking of possession or *qabd*, although it is *ḥukmī* and not *ḥaqīqī*.

Bay' Al-Dayn Bi Al-Dayn and the Futures Contract

Before proceeding with the juristic debate over the issue, it is necessary to ascertain the legal basis of the concept of *bay' al-kālī' bi la-kālī'*. First of all it should be noted that there is no verse or genuine *ḥadīth* prohibiting *bay' al-kālī' bi la-kālī'* or what is generalized later as *bay' al-dayn bi al-dayn*. The only *ḥadīth* reported on the issue is the *ḥadīth* of Musā ibn 'Ubaidah from Ibn 'Umar which indicates that the Prophet (PBUH) prohibited *bay' al-kālī' bi la-kālī'*. However, it is agreed by all early as well as modern Muslim jurists that this *ḥadīth* is weak⁵⁵ and, therefore, could not be the basis for any legal ruling.

However, an *ijmā'*⁵⁶ is claimed to have materialized on the meaning of the above "*ḥadīth*." But there are differences of opinion on what kind of *ijmā'* has materialized concerning the *bay' al-dayn bi al-dayn*. Thus, Ibn Taymiyyah and his disciple Ibn Qayyim are of the opinion that the *ijmā'* has materialized only in the case of *ibtidā' al-dayn* or the sale where both countervalues are deferred to a future date. Ibn Taymiyyah has not backed his claim by any evidence except the argument that there is no benefit in such an agreement.

⁵⁵ See Ibn Hajar, *al-Dirāyah fi Takhtij ahādīth al-Hidāyah*, Dār al-Ma'rifah, Beirut, vol. 2, p. 157; al-San'āni, *Subul al-Salām*, Dār 'Ihyā al-Turāth al-'Arabi, Beirut, 1976, vol. 3, p. 41; al-Shawkāni, *Nayl al-Awtār*, Dār al-Jil, Beirut, 1973, vol. 5, p. 157; Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 473. The only transmitter of this *ḥadīth* is Musā Ibn 'Ubaidah al-Zabadi about whom Imām Aḥmad said that "his transmission is not permissible (la Tahillu Riwayatuhu) and there is no *ḥadīth* ṣaḥīḥ on the issue." Al-Shaf'ī is also reported to have said the experts on *ḥadīth* consider this *ḥadīth* as a weak *ḥadīth* (yuwahhinūnahu). See Ibn Qudāmah, al-Mughnī, vol. 4, p. 64; al-Shawkāni, *Nayl al-Awtār*, pp. 254-255.

⁵⁶ Ibn Qudāmah, al-Mughnī, vol. 4, p. 64; al-Shawkāni, *Nayl al-Awtār*, pp. 254-255.

Furthermore, the weakness of this argument has been discussed at the beginning of this study where even some of the contemporary scholars who take an extreme position about the sale of debt for debt recognize the need, in modern transactions, for *ibtidāʿ al-dayn bi al-dayn*, due to its importance in modern commerce. Therefore, it should be allowed even under the basis of the principle of necessity.

Al-Subkī,⁵⁷ on the other hand, chooses another case (as it will be explained later) as the possible case where *ijmāʿ* may have materialized. Ibn Qayyim said there is no general text (*naṣṣ ʿām*) or *ijmāʿ* on the sale of debt but what is reported is the prohibition of *bayʿ al-kālīʿ bi al-kālīʿ*.⁵⁸ Given the difference of opinion about the area of *bayʿ al-dayn bi al-dayn* where *ijmāʿ* has materialized, it could be argued that this will reduce the reliability of such an *ijmāʿ*.

It should be noted that the misinterpretation of the issue of sale of *bayʿ al-kālīʿ bi al-kālīʿ* leads many scholars to include mistakenly many other forms of permissible sale under this concept. Thus, the first misconception is to consider *bayʿ al-kālīʿ bi al-kālīʿ* as synonymous with *bayʿ al-dayn bi al-dayn*, while in reality *bayʿ al-kālīʿ bi al-kālīʿ* even in its broader concept refers only to a sale where both countervalues are delayed. Yet, the reported “*ḥadīth*” on the issue is about *bayʿ al-kālīʿ bi al-kālīʿ* only.

However, some jurists tried to strengthen the authority of the above *ḥadīth* by referring to other *ḥadīth*, claiming that they convey the same meaning. Thus, al-Zuhaili,⁵⁹ for instance, refers also to the *ḥadīth* that *ribawī* items should not be exchanged unless it is done hand to hand.

Nevertheless, such an argument would be acceptable if the juristic debate about the prohibition of *bayʿ al-dayn bi al-dayn* were limited only to *ribawī* items, while in fact the jurists have extended this prohibition to every transaction involving the sale of debt. Moreover, if the message conveyed by the *ḥadīth* requiring that exchange of *ribawī* items should be hand-to-hand is to prohibit the sale of debt for debt, then, it does not need to be emphasized by the weak *ḥadīth* about *bayʿ al-kālīʿ bi al-kālīʿ*.

⁵⁷ Al-Subki, *Takmilat al-Majmūʿ*, vol. 10, p. 107.

⁵⁸ See Ibn Qayyim, *Ilām al-Muwaqqiʿin ʿan Rab al-ʿĀlamīn*, vol. 2, p. 9.

⁵⁹ Wahbah al-Zuhaili, *Bayʿ al-Dayn fī al-sharīʿah al-Islāmiyyah*, Dār al-Maktabi, Damascus, 1997, pp. 50–51.

Similarly, al-Zuhaili⁶⁰ referred to the *ḥadīth* in which the Prophet (PBUH) forbade the sale of what is in the wombs of animals which is generally considered as one of the bases of the concept of *gharar* and not that of the sale of debt, unless we maintain that the '*illah* in the prohibition of sale of debt for debt is *gharar*. However, if the '*illah* is *gharar*, then there is no *gharar* in the futures market, given the fact that the contract is guaranteed by the clearing house and any party affected as a result of the default of another person will get compensated through the clearinghouse.

Thus, Ibn Qayyim rightly pointed out that "regarding the sale of debt for debt there is neither implicit nor explicit text from the *sharī'ah* about its prohibition. On the contrary, the principles of the *sharī'ah* convey its permission."⁶¹ Before that Ibn Taymiyyah said: "there is no general text or *ijmā'* regarding the prohibition of the sale of debt for debt. The prohibition reported is only about "*bay' al-kāli' bi al-kāli'*."⁶²

An illustration of the above unfounded generalization is the claim by the Shāf'īs⁶³ and the majority of Ḥanbalīs that if A is indebted to B for say 50 *dinārs*, while B is indebted to A for 5000 *dirhams*, and they agreed to exchange what is in their *dhimmah*, then the deal will be illegal. The main argument for this prohibition is that it is the sale of debt for debt. It is clear that although this is an exchange of debt for debt, nevertheless it is definitely not the exchange of one delayed countervalue with another. In contrast, the above transaction fulfills a good objective by discharging the liability or *dhimmah* of both parties.⁶⁴ It should be noted that the above transaction is considered legal by the Ḥanafīs⁶⁵ and some Ḥanbalīs⁶⁶ while the Mālikīs⁶⁷ make it a condition that the payment due for both debts is similar.

⁶⁰ Ibid.

⁶¹ Ibn Qayyim, *Ilām al-Muwaqqi'in 'an Rab al-'Ālamīn*, vol. 2, p. 9.

⁶² Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 512.

⁶³ Al-Subki, *Takmilat al-Majmū'*, vol. 10, p. 107.

⁶⁴ See Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 472; Nazih Ḥammād, *Bay' al-Kūli' bi al-Kūli' (bay' al-Dayn bi al-Dayn) fi al-Fiqh al-Islāmi*, Markaz Abḥāth al-Iqtisād al-Islāmī, Jūmī'at al-Malik 'Abd al-'Azīz, Saudi Arabia, 1986, p. 25; Wahbah al-Zuhaili, *Bay' al-Dayn fi al-sharī'ah al-Islāmiyyah*, pp. 50–51; Muhammad Atīqī, "Bay al-Dayn Ṣuwaruhu wa 'Aḥkāmuhu Dirāsah Muqāranah," *Majallat al-sharī'ah wa al-Dirāsāt al-Islāmiyyah*, no. 35, August 1998, pp. 313–315; Isāwī Aḥmad Isāwī, "Bay' al-Dayn wa Naqlihi," *Majallat al-Azhar*, 1956, no. 2, pp. 165–6.

⁶⁵ Ibn 'Abidīn, *Rad al-Muhtār*, vol. 4, p. 239.

⁶⁶ Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 472.

⁶⁷ See *Jawāhir al-Iklīl*, vol. 2, pp. 10–11.

It is also claimed by the majority of Muslim scholars from the Ḥanafīs,⁶⁸ Mālīkīs,⁶⁹ Shāfīs,⁷⁰ and Ḥambalīs⁷¹ that a debt could not be transformed into a price for a *salam* contract because such a transaction will be reduced to a *bay' al-dayn bi al-dayn*. Ibn al-Mundhir⁷² has explained the *ijmā'* about its prohibition. To give an example, suppose A is indebted to B for 100 *dinārs* and B wants to transform this 100 *dinārs* into a price of a *salam* contract in exchange for which A shall bring to him ten bushels of wheat, for instance, by the end of the year. However, the claim by the majority that this kind of transaction is illegal has been rebutted by Ibn Taymiyyah, who stressed that there is no *ijmā'* on the above case as it is reported and it is not a kind of *bay' al-kālī' bi al-kālī'*, nor even does it have its meaning. Therefore, there is nothing illegal in such a transaction.⁷³

Similarly, it has been claimed that, in principle, *hawālah* (money transfer) shall be declared illegal because it is a kind of sale of debt for debt, but it has been allowed by way of exception due to the need for such a transaction.⁷⁴ The weakness of this argument is clear. In *hawālah* there is no deferment and therefore there is no case of *bay al-kālī' bi al-kālī'*. Moreover, the permissibility of *hawālah* is proven by a genuine *ḥadīth* where the Prophet (PBUH) was reported to have said: Delay of payment of debt by a wealthy person is an act of injustice (*zulm*). But if your debt has been transferred from a poor debtor to a wealthy debtor you should accept it.”

Having discussed the methodology adopted regarding the issue and where many cases have been included mistakenly, we have to refer to the cases with possible connotations of *bay' al-kālī' bi al-kālī'*. Addressing the issue of *bay' al-kālī' bi al-kālī'* or *bay' al-dayn bi al-dayn*, Nazīh Ḥammād stressed that the different forms of *bay' al-dayn bi al-dayn* are limited to the following five forms:

The first case is what is known in the Mālīkī school as *ibtidā' al-dayn bi al-dayn* or *al-nasī'ah bi al-nasī'ah*, namely, the exchange of

⁶⁸ See al-Kāsānī, *Badāi al-Sanāi*, vol. 5, p. 205; *Rad al-Muḥtār 'alā al-Dur al-Mukhtār*, vol. 4, p. 209.

⁶⁹ Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 169.

⁷⁰ al-Ramlī, *Nihāyat al-Muhtāj*, vol. 4, p. 1.

⁷¹ Ibn Quadāmah, *al-Mughnī*, vol. 4, p. 329; al-Buhūtī, *Sharḥ Muntahā al-ʿIrādāt*, vol. 2, p. 221.

⁷² Ibn al-Mundhir, *al-Ijmā'*, Mu'assasat al-Kutub al-Thaqāfiyyah, Beirut, 1993, p. 76.

⁷³ See Ibn Qayyim, *ʿIlām al-Muwaqq'in*, vol. 2, p. 9; Nazīh Ḥammād, *bay' al-kālī' bi al-kālī'*, p. 26.

⁷⁴ *Nihāyat al-Muhtāj*, vol. 4, p. 88; al-Suyūtī, *al-Ashbāh wa al-Nazā'ir*, p. 88; *Tashīl Minaḥ al-Jalīl*, vol. 3, p. 235.

two things, both delayed, or the exchange of one delayed countervalue for another. It is the most important form of *bay' al-kāli' bi al-kāli'*. Ibn Taymiyyah and Ibn Qayyim confined the prohibited form of *bay' al-dayn bi al-dayn* to this case. However, their agreement is contested. We have already dealt with this form of *bay' al-dayn bi al-dayn* while discussing the legality of the conventional forward contract, which is basically a contract where both countervalues are postponed to a future date. Therefore, the study addresses in this part the other forms of sale of debt due to their closeness to the futures contract and not the forward contract.

Thus, the first kind of *bay' al-dayn bi al-dayn* in this part is the sale of an established debt (*mustaqir*) in the *dhimmah* of the debtor, say one hundred *dirham* for instance, by a new deferred debt of a different kind than the first one. Suppose a person needs from another one hundred *dīnār*. He agrees with the debtor that he would like to take in exchange for this one hundred *dīnār* one hundred bushels of wheat to be delivered next year. Another example would be when a person (buyer) gives another (seller) one hundred *dirhams* for a specific amount of wheat, which should be delivered next year. At the due date, the seller said to the buyer, "I have no wheat to deliver for the time being, could I buy it from you for two hundreds *dirhams* which will be delivered next month?" Thus, the transaction becomes the exchange of one delayed countervalue for another delayed countervalue. It should be noted that al-Subkī considers it as the only form on which *ijmā'* has materialized. It is called by the Mālikīs *faskh al-dayn fi al-dayn* (extending the payment of debt in exchange of interest).⁷⁵ The reason behind the prohibition of such a transaction is that it is a means that may lead to *ribā al-nasī'ah*. However, Ibn Taymiyyah did not see any problem in such a transaction, since by such a deal the liability of the debtor would be discharged from the first debt, a move commended by the *sharī'ah*, although the debtor will be liable for the second debt.

The second form is the sale of an established *dayn* in the *dhimmah* of the debtor to a future date with an addition. It is seen when a person buys from another something with the price postponed to a future date. At the due date, he fails to get the necessary money to settle his debt. Hence, he suggests that the seller should buy it from him at a higher price on a future date. Suppose a person buys a car from another at RM 10,000 with the price to be paid three months later. At the due

⁷⁵ Al-Subkī, *Takmilat al-Majmū'*, vol. 10, p. 107.

date he fails to secure the RM 10,000 and suggests that the seller buys the car from him for 12,000 to be paid four months later. The reason behind the prohibition of such a sale is that the transaction involves *ribā al-nasī'ah*.⁷⁶ However, if he had suggested to him to buy the car at the same price as the original price, namely RM 10,000 or less, the transaction will be valid.⁷⁷

It is clear that such a transaction will lead to *ribā al nasī'ah* and, therefore, it may be argued that the prohibition of such a transaction is not because it involves the sale of debt for debt, but for its involvement of *ribā*.

The third case is the sale of a debt to a third person at a price to be delivered on a future date. Suppose one person needs from another one hundred bushels of wheat from a previous contract to be delivered next month. Before taking delivery, he resells that one hundred bushels of wheat to a third person for RM 1000 to be delivered three months later. The reason behind the prohibition of such a sale is the possible inability of the seller to deliver the subject matter of the contract. This case is similar to the case of sale before taking possession discussed above. However, if we apply this explanation to the futures market it will not be an issue at all. The clearinghouse will guarantee all contracts.

The fourth case involves selling a debt to a third person at a price to be paid immediately. Suppose a person is indebted to another for a car to be delivered two months from now then; he sells it to a third party for a price to be paid immediately. This is declared by the majority to be an invalid transaction while the Mālikis allow it on eight conditions which could be summarized into two main categories: it should be (a) free from *ribā* and (b) free from *gharar*.

It is clear from the above elaboration that although some scholars have cited *ribā* as one of the causes for the prohibition of the sale of debt for debt, it seems that *gharar* is the major cause. However, a limited kind of *gharar* is acceptable in the *sharī'ah*, while an excessive amount will render a contract illegal. This concept of *gharar* has close connection with speculation, which could also be excessive and lead to market collapse or could be a limited, which is not only desirable but also necessary sometimes. The following chapter will elaborate on the regulation of the futures industry in order to avoid market collapse.

⁷⁶ See *Minah al-Jalil*, vol. 2, p. 562; al-Zurqāni, *Sharh Khalil*, vol. 5, p. 81.

⁷⁷ *Ibid.*

CHAPTER SEVEN

FUTURES MARKET REGULATION

Intermediaries in the Futures and Options Market

Intermediaries in the futures and options market are people who trade or provide advice on trading to investors. Under the futures industry Act 1993, six types of intermediary are recognized: Futures Brokers, Futures Broker Representatives, Futures Fund Managers, Futures Fund Manager's Representatives, Futures Trading Advisers and Futures Trading Adviser's representatives. However, among all the intermediaries mentioned here the broker plays the most important role.

In highly competitive environment commodity broking is an important part of modern trading. "A future broker, like a stockbroker, is essentially an agent or intermediary who buys and sells on behalf of clients in return for a commission; he can also act as principal in certain transaction."¹

Under the futures industry Act 1993, Futures Brokers must be in the form of a corporation. Thus, Futures brokers in the Malaysian context, for instance, refer to companies which are member of the exchange in which they trade and agree to abide by its business rules. The basic functions of futures brokers are: to represent their clients in placing orders in the market to collect margins from the clients to provide basic accounting records and transaction to their clients and to advise and to recommend to their clients for their trading programs. Futures brokers must execute all orders for trading in futures and options contracts on the exchange. This means that, besides being licensed under the Futures Industry Act, a futures broker must be a member of an exchange company the rules of which he shall abide by.²

¹ David Courtney and Eric C. Bettelheim, *An Investor Guide to the Commodity Futures Markets*, London, Butterworths, 1986, p. 58.

² See, *Malaysian Futures and Options Examination Guide, Module 1: Regulation*, 1997, pp. 1-22; Low Chee Keong, *Securities Regulation In Malaysia* Malayan Law Journal Sdn Bhd, Kuala Lumpur 1997, pp. 178-179.

Thus a futures fund manager is a person who raises money from investors in order to use it, whether in part or in total, in the trading of futures contracts. In other words, futures managers are companies' funds that specialize in trading in futures contracts. The funds operate very much like unit trusts and enable small investors to pool their resources for management by futures fund managers. Employees of futures fund management are referred to as futures fund manager representatives.³

The third category of intermediary is the futures trading adviser. This could be a company or an individual. It provides advices and analysis to clients who are interested in investing in the futures market. Thus, although a futures trading adviser may not conduct business as a broker he serves principally as an advisor to investors. The advisory role includes the business of advising other persons about trading in futures contracts or engaging in the publication of futures reports. Recommendations made by the adviser must be based on reasonable grounds considering to the needs and financial situation of the investor, and to the subject matter of the recommendation. The investor has the right to claim damages from the advisor when it can be established that the loss was caused by the unreasonable recommendation of the adviser. Obviously, the futures trading adviser is not obliged to follow the instruction of the futures broker. This is because a futures trading adviser does not deal with client money and property in connection with futures contracts.⁴

It should be noted that all the intermediaries in the futures and options market must comply with the relevant trading practices as set out in Part V of the Futures Industry Act which includes sections 49 to 56. The sections deal with the issue of timely information to be provided to the client by the broker who should make out a contract note to the client not later than the next trading day beginning from the day of execution irrespective of the fact whether he entered the futures contract as principal or agent.

Moreover, when the broker is trades as principal in a futures contract he should inform the person with whom he is trading that he is acting in the transaction as principal and not as agent. More importantly, the broker is required to separate the money, property and documents of his customer from his own. Clients' fund cannot be withdrawn from

³ Ibid.

⁴ Ibid.

the segregated account except for the purposes of the payment of deposits and margins, the payment of debts due to the broker from the clients, and for monies drawn on clients' authority. Brokers are also not permitted to use monies belonging to one client financing the trade of another client or of the broker himself. This is to ensure that there is no misuse of the client's funds.

Furthermore, the futures broker should not open a futures contract account for a customer unless he furnishes the customer with a separate written risk disclosure document. More importantly, the futures broker should give priority to the customer order unless the customer's instructions require that. Thus he should not enter into a transaction of purchase or sale of futures contracts, either as principal or on behalf of an associated person, in case a customer of the futures broker who is not associated with him, has instructed the futures broker, to purchase or sell, futures contracts of the same class and he has not complied with the instruction. The purpose of not allowing the broker to trade ahead of their clients' orders is to ensure that the clients are given the preference over the broker in obtaining the best price in the market.

Finally, it is worth noting that contravention of any of the above provisions renders the person liable, upon conviction, to a maximum fine of one million ringgit and a term of imprisonment not exceeding ten years. Besides the provisions of the Futures Industry Act regarding the broker's functions, COMMEX business rules address the issue as well. Thus, rule 302 stipulates that a broker must maintain a minimum Adjusted Net Capital of RM 500.000 or 10% of the margin required to be paid to the clearinghouse or to any other party or clearinghouse organization. If a broker's Adjusted Net Capital falls below the specified level, the broker must immediately report this to the Compliance Committee as well as lodge the necessary financial statements, returns, record, etc.

Rule 303 deals with the activities prohibited for a broker. They include trading in futures contracts on a futures exchange or a specified exchange without the prior consent of the Exchange. Moreover a broker is prohibited from trading on behalf of his clients without their instructions. In addition, he is prohibited from trading in contravention of the business rules of that exchange. Furthermore, he should not execute the instructions of a person to trade in futures contracts unless the instructions executed affect a trade in COMMEX or a futures exchange. Similarly, the broker is forbidden to cheat or attempt to cheat or commit fraud. On the other hand, a broker is required to have an "operation manual"

that sets out the procedures to supervise the types of business which he engages in, and supervise the activities of officers, employees, agents and representatives.

In addition, the Business Rules specify that a broker must maintain internal records of orders received and orders executed for clients which include client names, account numbers, descriptions of the contracts entered into, including the underlying instrument, delivery settlement-month and year, types of order, number of lots and price. In addition, the type of instructions to trade in contract should be specified whether it is an order to buy or to sell, including the date and time of receipt, transmission and execution and the person who received and executed those instructions. Members must also maintain all records for a period of 5 years.⁵

Looking at the role of brokers in the futures market from an Islamic perspective it could be said that these functions fall under the concept of *samsarah* or *wakālah bi 'ajr* in Islamic law. Thus, almost all modern principles of brokerage could safely be accommodated in Islamic law except the issue of brokers borrowing with interest which definitely must be avoided in any possible Islamic futures market.

Meanwhile, the other regulations governing the industry such as the financial capability of a broker, his duty not to trade against his client, to give priority to his customer's order or to segregate his customer's fund are administrative requirements for smooth running of the market and for the protection of investors and could be easily adopted in Islamic law under the basis of *maṣlahah*.

The Fidelity Fund

Sections 58 to 78 of the Futures Industry Act require COMMEX to establish and maintain a fidelity fund consisting of, *inter alia*, all money paid to the exchange by futures brokers, by exchange companies or by an insurer pursuant to a contract of insurance or indemnity. In addition, it consists also of profit acquired from time to time from the investment of the fidelity fund and all other moneys lawfully paid into the fidelity fund including donations and legacies.

⁵ See, *Malaysian Futures and Options Examination Study Guide Module 5: COMMEX*.

The purpose of the fidelity fund is to compensate persons who have suffered monetary loss because of a default committed in the course of or in connection with trading in futures contracts in a futures market of an exchange company by a futures broker or by any director or employee, as the case may be.

However, the exchange company is not obliged to consider and determine a claim against the fidelity fund unless the person making the claim has satisfied the exchange company that he had made all efforts (other than a legal action in court) to recover the loss from the futures broker in relation to whom the claim arose or from any other person who is liable for the loss.

On the other hand, it should be noted that the amount of compensation which any person is entitled to as a claim from the fidelity fund is the amount of the actual pecuniary loss suffered by him including the reasonable cost of and disbursements incidental to making and proving his claim less any amount of value of money or other benefits received or receivable by him in reduction of the loss from any source other than the fidelity fund.

Looking at the functions of the fidelity fund from an Islamic point of view, it is clear that these functions are administrative matters necessary for the smooth running of the market and it could be easily accommodated under the concept of *maṣlahah*. Moreover, the contributors to the fidelity fund intend to benefit from their involvement in the futures market, to protect its continuity and at the same time to share any loss that might happen through their contribution to the fidelity fund. Indeed this is a positive kind of cooperation which does not contradict any principle of Islam.

Futures Market Regulation

Every futures market exchange has its own rules and regulations although generally there are some points of similarities. In the present study we will focus on the regulation of the Malaysian futures market. Until recently, the regulatory framework of the Malaysian futures and options market was divided into two segments. One dealing with commodity futures and the other with financial futures and options. Thus, trading in commodity futures used to be regulated by the Commodities Trading Commission, or CTC, a self-regulatory organization established under the Commodities Trading Act. However, following the amendment of

the futures industry Act in April 1997, The Commodities Trading Act 1985 was repealed as well as any subsidiary legislation made or deemed to have been made under the repealed Act was revoked.⁶ As a result, futures and options are regulated by the Securities Commission pursuant to the Futures industry Act 1993, the futures industry (Amendment) Act 1995, the Futures Industry (Amendment and Consolidation) Act 1997, the Futures Industry (Amendment) Act 1998.

The Securities Commission was established in March 1993 under the Securities Industry Act 1993 (SCA). It is a statutory body whose primary responsibility is the regulation of the Malaysian securities and futures markets.⁷

The Securities Commission's functions which are relevant to the futures industry include the following:

1. Advising the Minister on all matters relating to the futures industry.
2. Regulating all matters relating to futures contracts.
3. Supervising and monitoring the activities of the exchange and clearing house.
4. Taking all reasonable measures in order to maintain the confidence of investors in the futures market by ensuring adequate protection for such investors.
5. Promoting and encouraging proper conduct amongst members of the exchange and all holders of licenses under the Futures Industry Act.
6. Encouraging and promoting self regulation by professional associations or market bodies in the futures industry.
7. Issuing licenses, supervising all licensed persons and maintaining and promoting the integrity of all licensed persons in the futures industry.

It is worth noting that besides the regulatory activities of the Securities Commission, the futures exchange and the clearinghouse have their own internal business rules. In other words, the Securities Commission concerns itself with general policy formulation, licensing, product and

⁶ Art 14, sect 1–2 Futures Industry (Amendment and Consolidation) Act 1997. Also, See Low Chee Keong, *Securities Regulation in Malaysia* Malaysian Law Journal, Kuala Lumpur, 1997, p. 5.

⁷ See, Securities Commission, *Malaysian Futures and Options: Regulation Module 1*, p. 26.

market approval, and prosecution while leaving the day to day supervision of the market, approval of entry into the industry prudential control and membership regulatory responsibility to the exchange and the clearing house.⁸

The supervisory role of the Securities Commission as well as that of the exchange and the clearing house to preserve and promote the integrity of the market and to protect the investors from improper conduct could easily be accommodated under the principles of the institution of *ḥisbah* in Islam, which has the supervision of the market as the most important part of its various functions. *Ḥisbah* is generally defined as the institution which promote what is good and forbid what is improper (*wilāyatun taqūmu ‘alā al-’amr bi al-ma’ rūf wa al-nahyi ‘an al-Munkar*).⁹

The institution of *ḥisbah* was a shining example and direct reflection of the development of Islamic civilisation throughout the centuries when Islamic principles were observed and implemented by Muslims. It developed from a small institution concerned with the supervision of the market to an institution comprising various departments and dealing with almost everything that affects the life of the Muslim community ranging from economics, workers’ rights, medicine, security, city planning, animal care, the environment and the welfare of students. In all these areas the *muḥtasib* was performing his duty with justice, patience, and care without jeopardizing the personal privacy of the individual.¹⁰

The Prophet frequently undertook inspections of the market to check on the application of the economic principles of the *sharī‘ah* from engaging in improper behaviors, and thus he may be described as the first *muḥtasib* in Muslim history. During of his inspection, as reported in a widely known tradition: “the Messenger of God (peace be upon him) approached a stack of food (i.e., wheat) and inserted his hand, his fingers reached something moist. What is this, food merchant? The Prophet asked. The merchant answered: It has been affected by rain, Messenger of God. Then the Messenger of God asked: why not put the

⁸ Ibid., pp. 26–27.

⁹ Al-Māwardī, *al-Aḥkām al-Sultāniyyah wa al-Wilāyāt al-Diniyyah*, Dār al-Fikr, 1983, p. 207; Ibn Taymiyyah *al-Ḥisbah fi-al Islām*, al-Madīnah al-Munawwarah, al-Jāmiyah al-Islāmiyyah, n.d., p. 91.

¹⁰ Al-Māwardī, *al-Aḥkām al-Sultāniyyah wa al-Wilāyāt al-Diniyyah*, Dār al-Fikr, 1983, p. 207; Ibn Khaldūn *al-Muqaddimah*, (‘Ali Abd al-Wāhid edition), Dār al-Fikr, Cairo, 1960, p. 576; Ṣubḥī ‘Abd al-Mun‘im, *al-Ḥisbah fi al-Islām bayn al-Nazariyyah wa al-Ṭatbīq*, Dār Riyāḍ al-Ṣāliḥīn, Cairo 1994, pp. 14–24.

moist part on the top of the stack so that people can see it? And he added: "He who cheat us is not from us".¹¹ Permanent staffs were also appointed as *muḥtasib* during the time of Prophet. These include Sa'īd ibn al-ʿĀṣ, ʿAbd Allāh ibn Sa'īd ibn al-ʿĀṣ, ʿUmar ibn al-Kaṭṭāb, Samrah al-Asadiyyah and al-Shifā' bintu ʿAbd Allāh.¹²

The present study is concerned about the role of the *muḥtasib* in market's supervision. The *sharīʿah* sets out economic standards and rules that Muslim should follow. Thus, the *muḥtasib* regulated the market activities in a number of ways. Cited bellow are some of the important ways:

- First, the *muḥtasib* would see that resources did not flow to the production and distribution of goods and services which are categorically *ḥarām* in the *Sharīʿah*.
- Second, he would keep a strict watch on the supply position of essential articles especially foodstuff. At times of shortage he could compel the hoarders to bring out their stock to the market (*iḥtikār*).
- Third, all trade had to be done in the open market. Secret dealings by the traders at their homes, warehouses and behind closed doors could disturb the supply flows and thus interfere in the establishment of a natural price level.
- Fourth, the trades were not allowed to collude to bid up prices artificially (*najash*). This clearly indicates a necessity for anti-monopoly measures by the present day state.
- Fifth, the traders were not allowed to form groups to push newcomers out of the market. Free access to market was ensured to anyone who wanted to enter the market.
- Sixth, the urban traders were not allowed to meet the rural suppliers on their way and to buy their products at cheaper rates, keeping them in darkness about the market condition because such an exercise provides undue profit margins to the economically powerful sections at the cost of the unaware villagers (*talaqqī al-rukbān*). Moreover, this could lead to cut-throat competition between urban merchants to reach the rural suppliers on their way and thus lead to an unhealthy competition. It suggests that the *muḥtasib* would have

¹¹ Muslim, *Ṣaḥīḥ Muslim*, Kitāb al-Īmān, ḥadīth no. 164.

¹² See, Ibn Ukhuwwah, Muḥammad Ibn Muḥammad, Ma'ālim al-Qurbah fi 'aḥkām al-Ḥisbah, Maktabat Wahbah, Cairo, 1976, p. 38; Ibn Ḥajar, *al-Iṣābah fi Marifat al-Ṣaḥābah*, Cairo, vol. 2, p. 47.

to play a decisive role in disseminating market information among the rural suppliers to keep them abreast of the market trends. This would automatically discourage the tendency to buy cheaply from the ignorant farmers.

- Seventh, sometimes, rural suppliers were provided accommodation, hotels and rest shelters near the market place so that they could hold on for a few days and assess the market for themselves before entering into a bargain. The idea was to strengthen the bargaining position of the rural suppliers who could be exploited in urban centers if they did not have a place to stay for a few days.
- Eighth, the middlemen, who did not add any utility to the products but only reaped margins from buyers and sellers, were disbanded (*bay' ḥāḍirin li bādin*). This was to eliminate a class of exploiters and to streamline the supply flows.
- Ninth, the interest of merchants as a class was also protected against dumping in the market by a minority of merchants. If a minority of traders could manage to sell a product at an abnormally lower price than the prevalent market-rate, they were prohibited to do so, as such a trend could damage the interest of the majority. It implies that if an individual or a small group of businessmen introduces cheaper modes of production, it may lead to mass-scale technological obsolescence, unemployment and plant redundancies.
- Tenth, the traders and craftsmen were not allowed to hide the defects of a product. Nor were they allowed to make false oaths to sell their products. It suggests that the *muḥtasib* may have to regulate the role of advertisements in the present day context. The labels of products and advertisements through commercial media may be scrutinised prior to display to ensure the accuracy of their appeals.
- Eleven the *muḥtasib* also checks any transactions involving *ribā* such as (*bay' al-ṣarf*). Thus, he may lay down forms of agreement permissible in the *Sharī'ah* and those that may involve *ribā*.
- Twelve, of the conventional duties of the *muḥtasib* was to compel debtors to repay their debts on due dates if they had means to do so. In case the debtor was unable to meet the claim till a later date, he would intervene to get extension from the creditor. And in case the debtor was too indigent to honor the debt, the *muḥtasib* would arrange help from the *Zakat* fund.¹³

¹³ See, Al-Māwardī, *al-Aḥkām al-Sultāniyyah wa al-Wilāyāt al-Diniyyah*, pp. 207–210; Ibn Taymiyyah *al-Ḥisbah fi-al-Islām*, pp. 91–99; Ibn Ukhuwwah, Muḥammad Ibn

*Trading Offences Under the Futures Industry Act
and Islamic Law*

To deter undesirable and fraudulent practices in the market the Futures Industry Act deals with the trading offences under ss. 79 to 88. These provisions cover false trading, bucketing, dissemination of information about false trading, manipulation and cornering, devices to defraud, false and misleading statements, abuse of information obtained in official capacity, falsification of records and the penalties for these offences. They aim at discouraging and preventing unfair use of advantageous positions and price distortions.

The integrity and efficiency of the futures market should rely solely on the natural forces of supply and demand. Thus, no person is allowed to create or cause to be created or do anything that is intended to create a false or misleading appearance of active trading in futures contracts on a futures market, or false or misleading appearance with respect to the market, or the price of trading in futures contracts on the futures market”.

S. 81 states that “No person shall circulate, disseminate or authorize or be concerned in the circulation or dissemination of any statement or information to the effect that the price of trading in a class of futures contracts will, or tend to, rise or fall because of the market operations of one or more persons, who know that the operations are conducted in contravention of section 79.”

S. 84 similarly reads “No person shall, directly or indirectly, for the purpose of inducing the purchase or sale of a futures contract, make—

- (a) Any statement which, in the light of the circumstances in which it is made, is false, misleading or deceptive with respect to any material fact;
- (b) or any statement which, by reason of the omission of a material fact, is rendered false or misleading.

Muḥammad, Ma‘ālim al-Qurbah fi Ahkām al-Ḥisbah pp. 45–67 Muhammad Akram Khān, “al-Ḥisbah and the Islamic Economy” in *Public Duties in Islam*, the translation of the Ḥisbah by ibn Taymiyyah, translated from the Arabic by Mukhtar Holland, the Islamic Foundation 1982, pp. 135–151; Cengiz Kallek, “Socio-Political Economic Sovereignty and the Market of Medina”, *Journal of Islamic Economics*, vol. 4, Issue 1&2 July 1995, pp. 1–14.

S. 86 addresses the issue of abuse of information obtained in official capacity in his own or any other person advantage directly or indirectly. It holds that: "Any person who in relation to trading in futures contracts, has any information, which if generally known, might reasonably be expected to affect materially the price of the subject matter of such trading and which—

- (a) he holds by virtue of his official capacity or former official capacity;
- (b) it would be reasonable to expect a person in his official capacity or former official capacity not to disclose except for the proper performance of the function attached to that official capacity; and
- (c) he knows is unpublished price-sensitive information in relation to an underlying instrument which is the subject of futures contract, shall not make improper use of such information to gain directly or indirectly, an advantage for himself or for any other person.

It is not surprising that among the restraints imposed on futures market participants is the prohibition is against price manipulation. This prohibits all activities that cause or maintain an artificial price for a commodity future. An artificial price is one which is different from the one that would result under free market operation of supply and demand.¹⁴ In this regard the Futures Industry Act states in section 82 that: "No person shall, directly or indirectly, (a) manipulate or attempt to manipulate the price of futures contracts that may be dealt in on a futures market, or of any underlying instrument which is the subject of such futures contract; or (b) Corner or attempt to corner any underlying instrument which is the subject of a futures contract".

The prohibition of defraud is another issue crucial for the success of any futures market. Section 83 of the Futures Industry Act states that "No person shall, directly or indirectly, in connection with any transaction with any other person involving trading in futures contracts;—

- (a) Employ any device, scheme or artifice to defraud that other person;
- (b) Engage in any act, practice or course of business which operates as a fraud or deception, of that other person; or

¹⁴ See David Courtney & Eric C. Bettelhim, *An Investor Guide to the Commodity Futures Markets* Butterworths, London, 1986, p. 44.

- (c) Make any false statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances in which they were made, not misleading.

Finally the FIA addresses the issue of falsification of records whether by directors, employees or agents. It states that, “No director, manager, officer, auditor, employee, representative or agent of an exchange company, a futures broker or futures trading adviser shall—

- (a) Make or cause to be made a false entry in any book or record or any report, slip, document or statement of the business, affairs, transaction, conditions, asset or accounts of the exchange company, futures broker or futures trading adviser.
- (b) Omit to make an entry in any book or record or in any report slip, document or statement of the business, affairs, transaction, conditions, asset or accounts of the exchange company, futures broker or futures trading adviser or cause any such entry to be omitted; or
- (c) Alter, delete, conceal, or destroy an entry in any book or record or any report, slip, document or statement of the business, affairs, transaction, conditions, asset or accounts of the exchange company, futures broker or futures trading adviser or cause any such entry to be altered, deleted concealed or destroyed”.

The above provisions are all acceptable and could easily be accommodated in Islamic law given the fact that the attributes of truthfulness, honesty, justice and righteousness are precisely what Islam requires every Muslim to observe in all aspects of his life. It is not only required for legal purposes but also moral and spiritual ones. Thus, dishonesty, injustice and fraud are regarded as moral wrongs which in addition to temporal punishment, if any, will be counted as sins and hence, subject to God’s punishment in the hereafter.

A truthful and trustworthy trader is not only credited in this world as having good standing and reputation among other traders and potential customers, but also from the religious point of view, he will be placed with the Prophets, the righteous and the martyrs in the hereafter. There are many sayings of the Prophet (PBUH) on this point. He said: “A trustworthy, honest and truthful businessman will rise up with the martyrs on the day of resurrection”.¹⁵ It is also reported that the Prophet

¹⁵ See, *Fatḥh al-Bārī*, Dār al-Maʿrifah, Beirut, vol. 3, p. 144.

(PBUH) said: “The two parties to a sale have the option to rescind the contract as long as they have not separated from each other. If both of them are truthful and honest they will be blessed in their sale but if they are secretive and liars, then the blessing of their sale will perish”.¹⁶ Moreover, these principles are not only required when a Muslim is dealing with his fellow Muslims but also with non-Muslims.

The above mentioned crimes such as manipulation, fraud, misuse of information or destruction of information could generally be accommodated under the concept of fraud (*ghish*), manipulation, (*najash*) or other similar concepts such as *buy' al-mustarsil*, *talaqqī al-rukbān* and the case of *tasrīyah*. Therefore, we will briefly describe these principles.

Najash for instance, refers to a person or institution which only participates in a sale by false bidding where an auctioneer has appointed one or several bidders to take part in bidding, in order to incite the others to make higher bids exceeding the real value of an article. In other words, it is when a person (*al-nājjish*) is acting in collusion with one of the contracting parties in order to raise the price. The prospective buyer might have thought that his highest bid was the reasonable value of the article, while, in fact it was not the case. The false bidder's agents bidding up the price to incite him to put in another bid, which is higher, had deceived him and the contract has then been concluded at that higher price.¹⁷ There is no doubt that the auctioneer's agents were not genuine traders. They just aim to deceive the real traders about the real price. This is regarded as a fraudulent statement.

Many *aḥādīth* have been reported from the Prophet (PBUH) in which he has prohibited *najash*. Thus, it is reported by Ibn 'Umar that the Prophet (PBUH) had forbidden *al-najash*.¹⁸ Since there is no clear law on the effect of *najash*, neither in the Qur'ān nor in the Sunnah, different views are held by Muslim scholars. They are all in agreement that a person who practices *najash* is committing a sin and he is morally blamed. However, there is a difference of opinion regarding the effect of *najash* on the contract as to whether it will be considered void or valid.

Another contract which could be a basis for the above provision in the Futures Industry Act is the contract of *mustarsil*. It is a contract of an easy-going customer who does not bargain and who is ignorant about

¹⁶ See, *Saḥīḥ Muslim*, vol. 4, p. 123.

¹⁷ Mohammad 'Ali Bahrum, *Misrepresentation: Study of English and Islamic Contract Law*, al-Rahmaniyyah Islamic Mission, Kuala-Lumpur, 1988, p. 156.

¹⁸ *Saḥīḥ Muslim* with al-Nawawi, Dār 'Iḥyā al-Turāth al-'Arabi, vol. 2 p. 108.

the market price. However, he trusts what the sellers say about the real value of a particular article.¹⁹ The parties involved in the contract have a fiduciary relationship in which the seller is entrusted with the buyer's confidence that he will tell the truth or reveal those facts which he is acquainted with. It normally happens when the buyer openly reveals to the seller to sell it at the market price. Upon having such a trust placed in him the seller is required by law to disclose the true value of the article and sell it at the market price. Any given price higher than the normal price would be regarded as fraud.

Fraud is one of the broad Islamic equitable concepts against deception. This concept is supported by numerous *aḥadīth*. In one of these *aḥadīth* the Prophet (PBUH) said: "One who cheats us is not from us".²⁰ The elements of fraud, as summarized by al-Sanhurī, are exploitation by means of trickery and the inducement of the contracting party into the contract.

Finally, the FIA states that any person who contravenes or fails to comply with any of the provisions of this Part shall be guilty of an offence and shall be liable on conviction to a fine not exceeding one million ringgit or to imprisonment for a term not exceeding ten years or both. This kind of penalty imposed in such offences, from the Islamic perspective falls under *t'azīr* (discretionary punishment). The authorities have full discretion to impose a suitable penalty based on public interest.

Besides the above measures, the integrity of the market is maintained through other means as well. Thus, to prevent extreme price change in one day, most futures exchanges limit the amount of daily movement of futures prices. This "daily limit" restricts the amount of movement of price above or below the settlement price of the previous day. For instance, regarding crude palm oil futures the daily price limit is RM 100 per metric ton above or below the Settlement Prices of the preceding day for all months, except the current month. Limits are expanded when the Settlement Prices of all three quoted months immediately following the current month. The daily price limits will remain at RM 200 when the preceding day's settlement prices of all three quoted months immediately following the current month settle at a limit of RM200. It should be noted that a market does not close because a daily

¹⁹ Mohammad Ali Bahrum, *Misrepresentation: Study of English and Islamic Contract Law*, 126.

²⁰ *Ṣaḥīḥ Muslim*, Dār al-Fikr vol. 3, p. 1155.

price is reached; it merely cannot trade past that point. Any amount of trading can take place at the limit if a trader is willing to take the opposite side, or of course a price can move down from limit up or up from limit down.

Moreover, in order to ensure the stability of the market price is not allowed to fluctuate more than RM 1.00 per metric ton. In addition, the integrity of the market is protected from excessive speculation through the speculative position limit where transactions are limited to 500 contracts net long or net short for any delivery month or all delivery months combined. This is also emphasized by the system of reportable position, which is limited to 100 or more open contracts, either long or short, in any one-delivery month. Moreover, a transaction limit where each single floor transaction shall not exceed 20 lots.

The above regulations helped a great deal in preserving the integrity and reliability of futures market. However, the futures contracts themselves fall short of overcoming the ever-increasing business needs for more sophisticated instruments of risk management. Thus, the options contracts were introduced due to their ability to address such need. This will be discussed next.

THE OPTIONS MARKET

CHAPTER EIGHT

CONCEPT AND SCOPE

Concept of Options

Though the forward contract has overcome some of the problems associated with risk especially price risk and provided the possibility of better planning of business, it is still associated with some other problems, such as the problem of double coincidence, the determination of price through bargaining which may affect the weaker party to the contract due to his urgency or information asymmetry and, more importantly, the problem of counterparty risk by defaulting to honor his obligation.

These problems have generally been addressed by the futures contract. However, the futures contracts themselves are still inadequate in some respects to meet later day business needs. In particular, there were two inadequacies that have prompted the search for further product innovation. In spite of the fact that while futures enable easy hedging by locking in the price at which one can buy or sell, it does not allow him to benefit from subsequent favorable price movements. Though one can easily reverse a futures position subsequently, the price at which reversal takes place will be at changed prices. Also there is the possibility that since there is now full exposure (no more hedge) subsequent unfavorable price movements could really hurt.

The second and more important inadequacy is the fact that futures are unfavorable for the management of contingent liabilities or contingent claims. There are liabilities or claims on a business entity that could arise, depending on an uncertain outcome. In other words, contingent claims or liabilities are business situations that involve at least two levels of uncertainty. In an increasingly turbulent world such situations have become commonplace and their management is much more important.¹

¹ See, Obiyathulla Ismath Bacha, "Derivatives Instrument And Islamic Finance: Some Thoughts for Reconsideration", p. 6.

Thus, options are needed due to their potential to manage such risks in a better manner.

Definition

“An option is a contract between two parties in which one party (the buyer) has the right, but not the obligation, to buy or sell a specified asset at a specified price, at or before a specified date, from the other party (the seller). The seller of the option, therefore, has a contingent liability or an obligation, which is activated if the buyer exercises that right”. Thus, “An option contract conveys the right to buy or sell an underlying commodity at a specified price within a specified period of time”²

“The important feature is that the buyer of the option is not obliged to complete the deal, and will do so only if changes in price make it profitable for him. The buyer of the option is protected from unfavorable market movements, yet he is able to profit from movement in the buyer’s favor. The risk of loss is carried by the seller, who charges the buyer fee for taking this risk. This fee is called the premium”³ A simple example may clarify the above definition. Suppose it is early September and you want to buy a new car. You select the type of the car you want and go to your local dealer. In the dealer’s showroom you decide on the exact specification of your car’s colour, engine, size, wheel trim etc. The car is on offer at £20,000 but you must buy the car today. You do not have that amount of cash available and it will take a week to manage a loan. You offer the dealer £100 if he will just keep the car for a week and hold the price. At the end of the week the £100 is his whether or not you buy the car. This is a tempting offer and the dealer accepts your offer. You have entered into an option contract in this case. It is termed as a call option. This means, you have the right to buy the car in a week but not the obligation. If during the week you discover a second dealer offering an identical model for £19,500, you will not take up your option with the first dealer. The total cost of buying the car is $£19,500 + £100 = £19,600$, which is cheaper than the first price

² Hans R. Stoll & Robert E. Whaley, *Futures and Options Theory and Applications*, South-Western Publishing Co., Ohio, 1993, p. 6.

³ Securities Commission and Securities Institutes Education, *Malaysian Futures and Options Registered Representatives (MFORR) course*, Kuala Lumpur, 1997, p. 2.

you were offered. However, if you find the car at a cheaper price from the second dealer, for instance, and buy the car from the first dealer, the car will cost a total of £20,100. If you decide not to buy at all, you will lose your £100 to the car dealer. Thus, you are hedging against a price rise in the car.

On the other hand, if the car you have bought a call option for is great in demand and there is a sudden price rise to £22,000 and a friend of yours also wants the same car and hears that you have an option to buy the car for £20,000 in a week time, after visiting the bank you decide that you cannot really afford to buy the car and therefore, you sell the option to buy to your friend for £200. This means the car dealer still gets his sale, your friend gets the car he wants and you make £100 on selling your option.⁴

A somehow more complicated example from the energy market may guide us to the practical use of options given the fact that the energy market is one of the markets where the use of options is growing very rapidly. An oil producer fears an oil price decline, due to hot summer weather. He is worried he may have to sell his oil too cheaply in the market. He anticipates that he will sell approximately 1,000 barrels a day in October at a price of about US\$20 per barrel. His expected receipts on 25 days of production are US\$500,000. The producer could use futures that would cost nothing in terms of upfront premium, but could actually lose him money if his view of the market is wrong. However, there are certain factors in the market that lead him to believe that there may be a short term market shortage that may well push up prices temporarily. He wishes to profit, in case of favorable move of the market, while saving himself from downside. In order to get an indication prices-trading situation, he puts up Dow Jones Telerate screens for NYMEX futures and options.

The current level of the November future is US\$17.49 per barrel. The producer decides to buy 25 put options on the NYMEX Light, Sweet Crude oil futures with a strike at US\$17.50 per barrel. This is slightly “in the money” (an option with a strike price more advantageous than the current market level of the underlying) and the cost will reflect this. The Dow Jones Telerate shows that the last trade went through at 26 cents per barrel against yesterday’s close at 29 cents. Volatility is

⁴ See, The Reuters Financial Training Series, *Introduction to Derivatives*, 1999, John Wiley & Sons (Asia) Singapore, pp. 10–11.

bringing market down, and our oil producer decides to deal through his broker at 26 cents per barrel. A total premium cost of $US\$0.26 \times 25,000$ barrels, this is US\$6,500.

There are two possible outcomes in the next month. Oil prices can rise or they can fall. Let us assume that the oil price can move $\pm US\$4.00$. First of all, if oil prices rise to US\$21.50 the producer will abandon his option and sell his oil at a higher level. This would benefit him $25,000 \times US\$1.50$ which is equal to US\$537,500, a gain of US\$7,500 over his original estimate. But his option premium cost him US\$6,500, which must be deducted to give the final figure of US\$531,000, equivalent to US\$21.24 per barrel. Secondly, if oil prices had fallen, to say US\$13.50, from their original level, he would have exercised the option to sell his oil at US\$17.50, netting an income of US\$431,000 after premium costs.⁵

Economic Benefits of Options

The reason that justifies an Islamic legal evaluation of options trading is the different benefits associated with these financial tools. Some of these benefits are recognized by some Muslim economists who are very closely involved in the development of an Islamic financial system and eager to extract benefits from any human innovation, which eventually could benefit the Muslim economy. Thus, El-Gārī, for instance, in his elaboration on the economic advantages and significant economic effects of options on the stock exchange, maintained that options contribute to the enhancement of market efficiency and hence fulfilling the objective of stock markets. In particular, options have the following benefits:

1. They bring about an increase in the liquidity of the market. It is noted that one of the main advantages of the stock market is its ability to provide investment opportunity while financing long-term projects. It can be short-term to the investor, which will increase the overall investment. The negotiable nature of options contracts leads to further accomplishment of this objective.

⁵ See, Francesca Taylor, *Mastering Derivatives Markets A Step-by Step Guide to the Product, Application and Risk*, Financial Times Pitman Publishing, London, 1996, pp. 242–243.

2. Options contracts lead to a reduction in the effect of fluctuations in the prices of securities. Studies have shown that the return gained by the investor in the long term is usually higher in case the standard deviation (or yield fluctuation) is smaller, even though the return is lower in case the annual yield is higher and the standard of deviation (or yield fluctuation) is also higher, because the lean year will eat up the return of the good years.
3. Investing in the stock market involves a high level of commercial risk due to price fluctuations and the influence of the moods of investors on the market. The current political and economic development also affect stock market investment.
4. Since investment decisions in the stock market almost totally depend upon future forecasts, any event believed to influence the economic situation will necessarily affect the market trends. For this purpose, investors need a method which is similar in nature to insurance. While preventing the unwanted occurrence investors can minimize its adverse effects. Options can play such a role.
5. Options give the investor the opportunity to rearrange his investment portfolio by choosing the most appropriate position for his preferences related to the risk return trade off. This method of achieving the required balance cannot always be attained by relying upon buying and selling shares, bonds and securities, because this may involve costly fees or it may not be possible all together. An investor can, through these derivative institutions, choose to take a higher degree of risk by selling options and obtaining a possibility of high returns. He may waive the expected yield by buying options instead of being exposed to high risks.⁶

In another place El-Gārī stressed that: “there are many legitimate and Islamically desirable uses of options in stock markets. In particular, the hedging aspect of options is quite in line with the recognized need of individuals, which is not contradictory to the *shari’ah*. The fact remains however, that an option contract should not have an existence independent of sale or lease contract”.⁷ Moreover, he maintained that while there is, obviously, plenty of room for speculators in put options

⁶ See, El-Gārī, “Towards an Islamic Stock Market” *Islamic Economic Studies*, vol. 1, no. 1, December 1993, p. 12.

⁷ El-Gārī, “Stock Exchange Transactions: Shari’ah Viewpoint”, *Encyclopaedia of Islamic Banking*, p. 170.

in particular; the need for such a contract is legitimate in most cases.⁸ He also added that it is necessary to point out the significance of the availability of options in contracts on the exchange markets considering the fact that they supplement the operation of these markets. It is, therefore, not useful to say that we should ignore them since their existence could create juristic problems. It is better to understand the real implications of the existence of such contracts and the purpose they serve and then tax them to achieve what we are seeking by methods allowing us to avoid the legal problems and complications.⁹

Fuad al-Omar and Mohammed 'Abdel Ḥaq on the other hand, suggested that "with the basic considerations in view, it is proposed that certain types of derivatives, mainly modified forms of options in stocks and Islamic financial certificates, will continue to render useful functions under Islamic financing. The modifications are needed to ensure that the price paid for any option is, in fact, the price of the underlying asset paid in advance, rather than the price of the option itself. This is necessitated by the fact that in Islamic financing, an option by itself, is not recognized as a marketable asset... derivatives may also play other useful role within the framework of Islamic financing. To work out fully such benefits, and make use of them, substantial practical and conceptual efforts would be required".¹⁰

On the other hand, Obeyathulla while defining the aim of his paper entitled "Derivatives Instruments And Islamic Finance: Some Thoughts for Reconsideration" said, "What is intended here is to provide a deeper understanding and appreciation of these instruments. How they evolved, why they are needed, their diversity of use and the serious handicap that could be posed to Islamic business from ignoring them".¹¹

Similarly, Obaidullah held the view that "The option is an important tool of financial engineering. Financial engineers often use options in the design of new financial contracts or in developing innovative strategies for financial problems, such as, management of risk".¹²

⁸ Ibid., p. 170.

⁹ See, El-Gārī, "Towards an Islamic Stock Market", p. 13.

¹⁰ Fuad al-Omar & Mohammed 'Abdel-Ḥaq, *Islamic Banking Theory Practices and Challenges*, Oxford University Press, 1996, pp. 92-93.

¹¹ Obiyathulla Ismath Bacha, "Derivatives Instrument And Islamic Finance: Some Thoughts for Reconsideration", pp. 1-2.

¹² Mohammad Obaidullah, "Islamic Options-Engineering Risk Management Solutions", *New Horizon*, May, 1998, p. 6.

Other Muslim economists who touched the issue of options and admitted their benefits in modern finance are Muḥammed Shāhid Ibrāhīm and Tariqqullah Khān.¹³

These are the testimonies of some Muslim economists regarding the usefulness of options in Islamic finance. Besides establishing the benefits of options, the opinion of these economists is also important in clarifying the stand of some scholars or Muslim jurists, especially those who have discussed the issue of options at the Islamic *Fiqh* Academy and concluded that there is no need for options in Islamic economics because they do not serve any benefit.¹⁴ In such a situation the opinion of Muslim economists is the one which should be considered because they have knowledge about this particular field whereas the task of the jurists is to ascertain the conformity of these contracts to the principles of Islamic law and whether these benefits could justify any formulation of a legally acceptable Islamic alternative.

Besides these benefits advanced by Muslim economists, we may refer to some other benefits recorded in the conventional options works. Thus, it is generally accepted that options provide an efficient mechanism for allocating risk from those who wish to avoid it and to those who are interested in bearing it. Options also provide an additional benefit in allocating risk because the profit function for option is different from the profit function for the underlying commodity or for a futures contract. The profits from options are asymmetric. Such an asymmetric payoff pattern is useful, for example, in dealing with situations that involve both quantity and price risk.

Consider a farmer who is interested in avoiding the risk associated with a drop in the price of the commodity that he grows. Before the harvest, the farmer does not know the size of the crop or the price. Selling futures against the crop will hedge the farmer against a price decline if the harvest were known, but a futures hedge will expose him to risk if the harvest fails and prices increase, because then the farmer will not have the wheat that he is committed to sell in the futures market. The farmer will take a loss in acquiring the wheat to deliver against the futures contracts. Buying a put option on the underlying

¹³ Islamic Finance. Net. "Islamic Financial Derivatives" (discussion forum) *International Journal of Islamic Finance and Services*, vol. 1, no. 1, April–June 1999, p. 9.

¹⁴ Mohammad Mukhtār al-Salāmī, "al-Ikhtiyārāt" *Majallat Majma' al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 241; Siddīq al-Ḍarīr, "al-Ikhtiyārāt" *Majallat Majma' al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 271.

commodity provides a more effective hedge against price and quantity risk than selling futures. If the prices fall, the put option is exercised (or liquidated at profit). If prices rise, the put option expires worthless, and the farmer realises the revenues from his crop regardless of the size of the harvest. The cost of this one-sided protection for the farmer is the put option premium.¹⁵ It should be noted here that options have sometimes the same hedging benefits of a futures contract. But they have also some additional benefits. The two primary advantages of options (as distinct from futures) are their limited risk characteristics and their flexibility.

Limited Risk

Buyers of options have limited risk because they can lose no more than the option premium. Holders of futures positions are required to pay up losses (in the form of margin as the market moves against them). These losses are theoretically unlimited. They will keep growing as the market continues to move unfavorably until the futures contract is closed out. Limited risk has also benefits to hedgers who desire to manage their risk. For them the option performs the function of setting either a maximum buying price or minimum selling price for a future transaction without locking in this price. If the physical market price is better at the time the transaction takes place, the hedger can take full advantage of it. Option sellers or writers do not have limited risk. Their risk position is more like that of the holder of an ordinary futures contract; but the seller of an option also earns the premium. Premiums earned by options sellers can be a useful source of income especially for those who deal in the underlying commodity and wish to increase their potential investment yield. For such users, holding the underlying physical commodity reduces the level of risk involved in selling options.¹⁶

¹⁵ Hans R. Stoll & Robert E. Whaley, *Futures and Options Theory and Applications*, pp. 11–12.

¹⁶ Securities Commission and Securities Institutes Education, *Malaysian Futures and Options Registered Representatives* (MFORR) course, p. 15.

Flexibility and liquidity

Among the many attractions of exchange-traded options is the fact that they are standardized. This allows them to be traded freely in the open market. Having bought an option, a trader can later take advantage of a favorable move in the market. This aspect of standardization is also one of the major reasons for the success of options exchanges. In a financial market, traders want to be able to trade quickly and at a fair price. They can do this if the market is liquid. A liquid market provides an efficient and cost effective trading mechanism with a high volume of trading. Standardising the options contract has helped in promoting liquidity. The standardized contract has a specific size and expiration date. The exchange standardizes the exercise prices at which options will be traded. With fewer exercise prices, there will be more trading available at a given exercise price. This too promotes liquidity.¹⁷

American and European Options

There are two fundamental kinds of options: the American option and the European option. An American option permits the owner to exercise at any time before or at the expiration. The owner of a European option can exercise only at the expiration. Thus the two options differ because the American option permits early exercise. If the option is at expiration, European and American options will have the same value. They can be exercised immediately or be allowed to expire worthless. Prior to expiration, we will see that the two options are conceptually distinct. Further, they may have different values under certain circumstances.

Consider any two options that are just alike, except that one is American and the other is a European option. By saying that the two options are just alike, we mean they have the same underlying commodity or stock and the same exercise price. The American option gives its owner all rights and privileges that the owner of the European option possesses. However, the owner of the American option has also the right to exercise the option before expiration if he desires. From these considerations, we can see that the American option must be worth at least as much as the European option.

¹⁷ See, Robert W. Kolb, *Option The Investor's Complete Toolkit*, New York Institute of Finance, United States, 1991, p. 7.

The owner of an American option can treat the option as a European option just by deciding not to exercise until expiration. Therefore, the American option cannot be less valuable than the European option. However, the American option can be worth more. It will be worth more if it is desirable to exercise earlier. In this case, the American option will be worth more than the otherwise identical European option. In some cases, the right to exercise before expiration will be worthless. For these situations, the American option will have the same value as the European option. In general, the European option is simpler and easier to analyze. However, in actual markets, most options are American options. We should not associate the names “American” and “European” in the sense of their geographic locations. In the present context, the names simply refer to the time at which the option holders can exercise these options.¹⁸ Although the American type of option seems to be much similar to some of the Islamic contracts, which could be designed as tools of risk management, such as *khiyār al-sharṭ* and *bayʿ al-ʿarbūn*, where the option could be exercised at any time during the agreed period, it seems that there is nothing which prohibits the use of the European form of option if the parties agree to do.

Types of Options

There are many types of options, such as, exotic options, compound options, options on options, lookback options and others. However, the present study is only concerned with the fundamental types of options namely, call and put options. A call option gives the holder the right to buy an asset within a specific period at certain price. A put option, on the other hand, gives the holder the right to sell an asset by a certain date at a certain price. The date specified in the contract is known as the expiration date, the exercise date, the strike date, or the maturity date. The price specified in the contract is known as the exercise price or strike price. The following examples illustrate the above two fundamental concepts.

¹⁸ Robert Kolb, *Understanding Options*, John Wiley and Sons, Inc., New York, 1995, pp. 5–6.

Example of a call option

Consider the situation of an investor who buys a European call option to purchase 100 Telekom Malaysia shares with a strike price of RM14. Suppose the present stock price is RM12, the expiration date of the option due after two months and the price of option to purchase one share is 50 cents. The initial paid premium is 5000 cents or RM50. Since the option is European, the investor can exercise only on the expiration date. If the share price on this date is less than RM12, he or she will clearly choose not to exercise. There is no point to buy at price of RM14 a share while its market value is less than RM14. As such, the investor loses the whole of the paid premium of RM50. If the share price is above RM14 on the expiration date, the option will be exercised. Suppose the share price is RM16. By exercising the option, the investor can buy 100 shares for RM14 per share. If the shares are sold immediately, the investor would make a profit of RM2 per share or RM200 ignoring transaction costs. When the initial cost of the option is taken into account, the net profit to the investor would be RM150.

It is important to realise that an investor sometimes exercises an option and makes a loss overall. Suppose in the above example the stock price of Telekom Malaysia is RM 14. 20 at the expiration of the option. The investor would exercise the option for a gain of $100 \times (RM14.20 - RM14) = RM20$ and realise an overall loss of RM30 when the initial cost of the option is taken into account. It is tempting to argue that the investor should not exercise the option in these circumstances. However, not exercising the option would lead to an overall loss of RM50, which is worse than the loss of RM30 in case the investor exercises. In general, call options should always be exercised at the expiration date if the stock price is above the strike price.

Example of a put option

Whereas the purchaser of a call option hopes an increase in the stock price, the purchaser of a put option hopes a decrease. Consider an investor who buys a European put option to sell 100 B Group's shares with a strike price of 90 cents. Suppose, the current share price is 86 cents, the expiration date of the option is due after three months, the price of an option to sell one share is 7 cent, and the initial paid premium is 700 cent. Since the option is European, it will be exercised only if the share price is below 90 cents at the expiration date. Suppose that the share

price is 65 cents on this date, the investor can buy 100 shares for 65 cent per share and, under the term of put option, sell the same shares for 90 cents to realise a gain of 25 cents per share or 2500 cents. Again, transaction costs are ignored. When the 700-cents paid premium for the option is taken into account, the investor's net profit is 1800 cents. Of course, there is no guarantee that the investor will make a gain. If the final stock price is above 90 cents, the put option expires worthless and the investor loses 700 cents.

Exchange Traded and Over-The-Counter Islamic Options

Although the present study is generally based on the assumption that the Islamic alternative for option trading will be exchange-traded options, the possibility of an Over The Counter Islamic options is not totally ruled out. More importantly, it is highly likely that it will precede the organized market, because over-the-counter markets generally precede organized exchange markets in futures and options. Thus, in the United States where the derivatives market developed prior to the inception of the Chicago Board Options Exchange in 1973, over-the-counter options on common stocks were arranged by put and call dealers. Moreover, in over-the-counter market delivery is usually implied. Therefore, given the fact that the issue of delivery is one of the points of criticisms against options in general from some Muslim scholars, a start with an over-the-counter market from Islamic perspective may help in highlighting the benefits of options in general and paving the way for the organized market. In addition, it should be noted that the growth in the organized market in the conventional system does not mean that over-the-counter market has declined in importance.

In recent years, over-the-counter market trading in derivative financial instruments has grown dramatically alongside organized markets in these instruments. This reflects the fact that over-the-counter forward and option contracts can be tailored to the needs of their retail customers. Institutions create over-the-counter forward or options contracts to offset their over-the-counter market positions.¹⁹ Thus, the main features of the two concepts need to be underlined briefly.

¹⁹ See, Hans R. Stoll & Robert E. Whaley, *Futures and Options Theory and Applications*, p. 15.

Exchange traded options are options that originated and are traded on formalised and government designated exchanges. In exchange markets, contracts are standardized and the clearinghouse is the buyer to every seller of a contract and the seller to every buyer. This eliminates default risk of option buyers, or the risk of failure of the seller to meet his or her obligations. Moreover, the standardization process makes it easy for market participants to deal in these instruments because no discussions or negotiations are needed to determine the contract specifications. The only item for negotiation is the price.

Under this arrangement, secondary market trading is possible because a buyer of a contract, who wishes to liquidate his position, does not need to search and find the original seller of the contract instead he may negotiate a transaction with any individual. In over-the-counter markets, in contrast, contracts are tailored to the needs of the transacting parties, and no clearinghouse exists. It is a contract between two parties who make their own arrangements for guaranteeing the contract's financial integrity. Secondary market trading is very inefficient in the over-the-counter markets because a buyer, who wishes to liquidate his position, is obliged to seek an agreement with the original seller of the contract.²⁰

A Brief History of Options Trading

Market players have used options on commodities and stock for several centuries. During the Dutch Tulipomania events of 1630s, tulip dealers granted growers the right to sell their tulip bulb crop for a set minimum price. For this privilege, the grower paid the dealer a fee. Tulip dealers paid a fee to the growers also for the right to buy the bulb crop at an agreed maximum price.

By the early 1820s, the London Stock Exchange was trading options on shares, and in the 1860s, there were over-the-counter options markets on both commodities and stocks in the US. The early exchange traded and over-the-counter options markets were not free from problems such as lack of regulation, contract default etc. The market got a bad name

²⁰ See, Franklin R. Edwards & Cindy W. Ma, *Futures and Options*, McGraw-Hill, Inc., United States, p. 491; Hans R. Stoll & Robert E. Whaley, *Futures and Options Theory and Applications*, pp. 14–15.

because of certain practices. One of these involved brokers being given options on a certain stock as an inducement, for them, to recommend the stock to their clients.

In the early 1900s, a group of firms set up what was known as the Put and Call Brokers Dealers Association. The aim of this association was to provide a mechanism for bringing buyers and sellers together. But it suffered from two deficiencies. First, there was no secondary market. Secondly, there was no mechanism to guarantee that the writer of the option would honor the contract and in case of default the buyer had to resort to a costly lawsuit.

Exchange traded futures contracts on commodities had been established on a number of exchanges in the 1860s, but options contracts on commodities were not available for about a century or so. Exchange trading on US stocks started in 1973 when the Chicago Board Options Exchange was established. In the 1980s, markets developed for options in foreign exchange, options on stock indices and options on futures contracts. It should be noted that the development of options contracts on commodities and shares has an early and separate development from that of other traded options.²¹ This distinct development has also had its repercussions on other aspects of option trading. Thus, as it will be explained later, the present study will be limited to options on commodities and shares.

Scope of Options

The scope of the discussion about options from an Islamic perspective needs to be defined, because many areas of investment in the conventional system using options may not be acceptable in Islam. For instance, interest rate option is obviously out of consideration. Similarly, index options are pure gambling as many Muslim jurists and economists described them. El-Gārī, for instance, says,

Obviously this is pure gambling. What one buys or sells (when one buys an index option) is a chance to win an amount of money not specified (the difference between current price and future price). Gambling in the

²¹ The Reuters Financial Training Series, *Introduction to Derivatives*, p. 71, John Hull, *Introduction to Futures and Options Market*, Prentice Hall, Inc., 1991, p. 5; Franklin R. Edwards & Cindy W. Ma, *Futures and Options*, p. 488.

sharī'ah is not permissible even for charitable purposes, let alone profit making.²²

Currency options is another area, which could not be admitted in Islamic finance. Some very authentic *aḥadīth* are clear that currency exchange must be hand-to-hand and any postponement to the future is illegal while the idea of an option, in contrast, is based on future expectations. Therefore, there is no room for compromise and the rules of the sunnah must prevail. Some writers have suggested the possibility of options in currency trading based on the opinion of early scholars. According to them it is possible to trade *fulūs* on a in future basis because *fulūs* were not genuine currency at that time but gold and silver. Thus, Obaidullah, for instance, says,

currency options pose some challenges for scholars and researchers and there are divergent views on the issue of the prohibition of *ribā* in currency exchange. The divergence is due to the process of analogy (*qiyās*) in which efficient cause (*'illah*) plays an extremely important role. The process of analogy is needed since gold and silver, which performed the function of money in the early days of Islam, have been replaced by paper currencies. It is a common efficient cause (*'illah*) which connects the object of the analogy with its subject in the exercise of analogical reasoning. The appropriate efficient cause (*'illah*) in the case of currency exchange contracts has been variously defined by the major schools of *fiqh*. Accordingly, jurists equate currency exchange with *bay' al-ṣarf* in which spot settlement or *qabd* by both the parties on the spot is insisted upon. Hence, options are automatically ruled out. Some others, primarily belonging to the Ḥanafī school permit deferment of obligation by one party or *bay' al-salam* in currencies and thus admit the possibility of options.²³

However, as it was discussed earlier in this study, the Ḥanafī opinion to which Obaidullah is referring to, is based on the ground of an analogy between *fulūs* and modern paper money. However, there exists discrepancy in this. Paper money is the only medium of exchange nowadays similar to gold and silver in the early days of Islam while *fulūs* when introduced were only a medium of exchange for less valuable items, while gold and silver were the major medium of exchange. Moreover, the idea of allowing deferred trading in *fulūs* is keenly contested even by the early jurists and the opinion, which fulfills the spirit of the *sharī'ah*

²² El-Gārī, "Stock Exchange Transactions: sharī'ah Viewpoint", *Encyclopaedia of Islamic Banking*, p. 170.

²³ Mohammad Obaidullah, "Ethical Options in Islamic Finance", p. 79.

and its objectives goes that deferred trading in *fulūs* is illegal. Thus, there is no possibility of currency option in Islamic finance and the scope of this study will be limited to options in commodities and shares.

Thus, addressing options contracts from an Islamic point of view means, first of all, assessing the compatibility of these contracts with the *sharī'ah* and identifying the points of difference with Islamic principles. Secondly, looking for the Islamic alternative, among the existing types of contracts that could produce the same benefits without contravening the principles of Islamic commercial law. However, if the existing Islamic types of contracts fail to provide the same benefits provided by the conventional options, is it possible to modify the conventional aspect of options so that it could comply with Islamic principles? However, if this step is not suitable, is it possible to extend the concept of some of the existing Islamic types of contracts within the framework of Islamic principles and based on the theory of freedom of contract and conditions in order to accommodate the already acknowledged benefits of conventional options?

Another issue that has been repeatedly raised in the prohibition of options is the claim that conventional options are pure gambling, which has no place in Islamic Finance. It should be noted that the concept of gambling and *gharar* are, sometime, confused to each other. Moreover, the claim of gambling in modern transactions is not limited to options. Similar claim was also made against the stock market transactions considered by some scholars as merely gambling which does not serve any useful economic purpose.²⁴

Options and Gambling

Concept and Definition

Gambling is generally defined as the voluntary risking of a sum of money called a *stake, wager or bet*, in the outcome of a game or other event.²⁵

Sears J in the *Richardson Greenshields of Canada (Pacific) Ltd v. Keung Chak-kiu and Hong Kong Futures Exchange Ltd* case taking wagering to be synonymous with gambling, supported the classical definition of

²⁴ See, Mohammed Ali El-Gārī, "Towards an Islamic Stock Market", p. 8.

²⁵ *The Encyclopedia Americana*, International Edition, Grolier Incorporated 2001.

Hawkins J in *Carlill v. Carbolic Smoke Ball Co* that the prerequisite of a bet or a wager is that two parties enter and one wins, one loses:

A wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, depend upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract.

Sears J also maintained that:

Gambling in law is either gaming or betting, or in colloquial terms reckless expenditure, but this element of risk does not convert a financial transaction into gambling. Investing in futures contracts is like dealing in any matters which may or may not occur in the future where one does not know the outcome and where a profit or loss may be made.²⁶

It is worth noting that it is the characteristic of being genuine commercial transaction that marks the difference between betting, wagering, gaming or gambling and entering into a future contract. The transaction is genuine because it was an open type commercial transaction, conducted in a publicly controlled exchange where what is being purchased is known to all person, with no hint of it being disguised as something else. Even the purpose of speculation does not transform the transaction into gambling. From the point of view of other parties of the futures contract such as the broker, the clearinghouse on which the contract is settled or offset, there is a genuine commercial transaction. The broker for instance, is not standing to lose or to gain but to earn a commission. Even the fact that only about two per cent of futures contracts involve physical delivery of the underlying commodity does not convert it into gambling as long as the parties did intend to enter into contract which may result into in delivery of acceptance of delivery.²⁷

²⁶ [1989] 1 HKLR, 476.

²⁷ See, Paul Latimer, "Futures Contracts and Gaming Laws", *The Company Lawyer International*, Australia, vol. 14, no. 3, pp. 67-71.

There is no doubt that the Qurʾān prohibited gambling (al-māʾidah 5:90) but, the issue is whether a specific transaction involves gambling not. The underlying object of a contract of gambling is risk and nothing else. It does not relate to the exchange or production of any goods or services.

The best example to illustrate this issue is the arguments and the counter arguments advanced in the discussion forum of the Islamic *Fiqh* Academy on the issue of options. Although the present study has addressed the issue of gambling briefly while addressing the issue of speculation, it is necessary to touch on some of these issues here due to their close link to options trading in particular.

This is also due to the fact some of the distinguished scholars, in that forum on options organized by the Islamic Fiqh Academy, adopted the issue of gambling as one of their argument against options. Al-Salami for instance said, “the closest thing to option in my opinion is gambling. The chance of each party in the contract to gain is based on the loss of his counterpart according to the movement of the market whether up or down”.²⁸ In support of this opinion Taqī al-ʿUsmānī went further saying, “Options are not identical to any of the known Islamic contracts. Moreover, the definition of gambling and that of options are similar because the options trader is paying his money in exchange for a risk... it is like the contract of insurance”.²⁹ Adding his voice to that of his colleagues al-Ḍarīr said, “option in currency trading is not a point of discussion because even the ordinary option of stipulation or *khiyār al-shart*, where the option is not exchanged with any thing, is not allowed in currency trading. Therefore, the illegality of currency option is obvious... concerning options in stocks, it is clear that one who is buying the stock of a specific company with option has no interest in owning the stocks of this company. It should be added that the legality of stock companies trading with the intention of gaining from price differential is a point of dispute between contemporary Muslim jurists, and al-Ḍarīr added, I prefer the opinion, which prohibits it even if the exchange does not involve option. Hence, when it is with option, it is more obvious and definitely illegal. Option in currency trading and

²⁸ *Majallat Majmaʿ al-Fiqh al-Islāmī*, 1990, vol. 1, p. 568.

²⁹ *Ibid.*, p. 572.

stocks is similar to gambling and there is no difference between it and looking for price differential³⁰

However, the above argument has been opposed by al-Taskhīrī in his reply, he says, “to describe these contracts as gambling needs strong evidence (which is not the case with the issue in question). Moreover, some have described insurance contract as gambling although the gap between insurance contract and gambling is very wide... indeed some may use these contracts to matters, which are close to gambling.³¹ But this should not affect the essence of the contract.

To defend his position, al-Salami replied that options are not like the ordinary known gambling but it could be used sometimes for that purpose.³² Then al-Ḍarīr takes the defense saying, “In reality options are not gambling but have some similarities with it. Moreover, describing option contracts as a gambling is not from us. This is the description of some American newspapers describing the American society as a casino of gambling, for it deals with options especially options in indices, which are based neither on commodity nor stocks nor any thing else as underlying assets, as it is quoted by some of the papers presented in this forum. Then how this cannot be described as similar to gambling if it is not the sister of gambling?³³

In a direct reply to this argument, Mohammad Mu'min says,

it has been repeated that the contract before us is similar to gambling, what is prohibited is gambling and not what is similar to gambling. Similarly what is banned is *ribā* and not what is similar to *ribā*. Moreover, winning profit from gambling is one sided, because one party gains without giving anything in return while in this case the premium is given in exchange to the right of option and the option's receiver benefits from it to manage his risk. Then, how receiving some thing in exchange of something else is illegal? In addition, some scholars have maintained that the objective of such transaction is only “the benefit” or *al-ribḥ* and nothing else (which is in this case the premium and the option). However, if the objective of a contract is the profit or the gain with the fact that the premium and the option are the means of this benefit, then on what ground such a transaction should be prohibited. Most of the contracts from which people are gaining are contract over an *ʿayn* (physical thing) or *manfaʿah* (usufruct) like the case in *ijārah*. Furthermore, it is contented that this contract involves risk. However, to a certain degree, risk is present in some

³⁰ Ibid., pp. 576–577.

³¹ Ibid., p. 582.

³² Ibid., p. 584.

³³ Ibid., p. 589.

legally accepted sale and leasing contracts too. Do we conclude that these contracts are illegal. In fact, risk is present in every contract of sale and a person could lose or gain from this or that contract. Do we conclude that these contract are illegal?³⁴

Intervening in this juridical debate some Muslim economists made some clarifications. Thus, Sāmī Ḥammoud says, “to say that this contract is similar to gambling is not true. It is not a gambling contract in the eyes of one who is expert in the field”³⁵ Lastly, Mundhir Khaf and ‘Abd al-Salām al-‘Abādī describes the options contract pointing to the difference between options in commodities and stocks on one hand and that of currencies and especially stock indices on the other. More importantly, underlining the fact in option trading, there is an exchange of a right with money, which is not definitely the case in gambling.³⁶

Although the right position seems to be clear from the above exposition of the different views, however, a brief comment is necessary to point out the implications of some of the above statements to the study of Islamic finance and specially that of options, commodities and stocks. First of all, although the opponents of options have realised a genuine difference between option in commodities and stocks on one hand, and that of currency and stocks indices on the other, they have not made any attempt to evaluate the two cases differently which resulted in a total confusion and generalization.

Secondly, they have drawn an analogy between options and insurance to invalidate options. However, although Muslim jurists have opposed the conventional form of insurance, a continuous effort to formulate the Islamic alternative was the objective of these jurists since then. Unfortunately, this was not the case with options where many have claimed that there is no need for such contracts for the Muslim economy and therefore, there is no need for an Islamic alternative.

Thirdly, al-Ḍarīr argued that he opted for the opinion that trading in stocks companies is illegal if the traders are looking for profit from price differentials and not the ownership of the of the stocks. However, if such an opinion is considered, it will not only prohibit commodity and stock trading either with options or without it. Besides, it will lead

³⁴ Ibid., p. 590.

³⁵ Ibid., p. 593.

³⁶ Ibid., pp. 595–598; pp. 603–605.

to the impossibility of developing any kind of an Islamic commodities and stocks market.

It is worth noting that al-Ḍarīr's argument that trading in stock of companies is illegal if traders are looking only to gain through price differentials and not the ownership of the stocks is unacceptable. However, it could be used at the same time as a counter-argument to those who allow stock companies trading despite the fact that it involves the idea price differentials while they prohibit options trading on the same ground.

Fourthly, it seems that the reason of labelling such a transaction as gambling might be their failure to differentiate between risk and gambling or the claim that a "pure right" is not property and, therefore, there is no contract of exchange at all in options trading. However, this claim has been proven wrong as elaborated above.

Thus, it is clear from the above statements that the claim that option in commodity and stocks, in particular is a kind of gambling, is unfounded because there is no legal or economic evidence to support that. It is interesting to note that the opponents of options in the above are argument also among those who opposed the legality of *'arbūn* during its discussion by the Islamic Fiqh Academy on the ground that one of the parties is benefiting from the other without any exchange and it is *harām*.

On the other hand, to consider options as a kind of gambling, because the parties involved are looking for price differentials, may also apply to *khiyār al-sharṭ* or *'arbūn*, which can also be used for that purpose. Yet, an importer may purchase some commodities from another trader residing in another country with *khiyār al-sharṭ* of three months for instance. He is concluding such a deal not because of the fear of being cheated by the seller as it is the fact in the *ḥadīth* of Ḥibbān Ibn Munqidh about *khiyār al-sharṭ*, but rather to benefit from a good market if his expectations are correct and confirm the contract. However, if his expectations are proven to be wrong, he will leave the term of the option to expire without confirmation since the price of the commodity in question falls sharply during this period, and therefore, he will not confirm the contract to face real loss. A similar scenario can also develop through *'arbūn*. However, we do not think anyone will venture to declare *khiyār al-sharṭ* or *'arbūn* in such transaction illegal on the ground of being used for price differentials unless we follow al-Ḍarīr's view that trading in stock of companies is illegal because the traders are looking only to

gain through prices differential and not the real ownership of the of the stocks. And if this is the ground to invalidate options then, *khiyār al-shart*, *'arbūn* or trading in stock companies, as practiced nowadays by Islamic financial institutions, should be declared illegal.

Some other scholars on the other hand, did not see even speculation as gambling if it is based on information and not on manipulation and distortion of the market. In other words, a limited kind of speculation is an ordinary market practice and could not be equated to gambling. Thus, Ahmad Abdel Fattah El-Askar says:

Speculation has mistakenly been equated with gambling. This need not be the case. Speculation involves a great deal of computation, which in the light of the highly developed computation techniques of today can hardly be a game of chance. It is a process that relies on the analysis of a lot of economic and financial data, companies financial reports, political decisions, information about management skills and aptitude as well as the personal profile of decision makers. All this information is analyzed before a decision of buying and selling securities that requires a great deal of knowledge and skills. But the notion of equating speculation with gambling is a misconception that is inherited from the past when speculation was more of a personal guess than a very careful calculation. Nor can the stock exchange be equated with gambling casinos. It is a complete market in which very little, if ever, is left to chance. Neither can the market afford a mere chance in its operations nor can countries' economies sustain it.³⁷

Similarly, commenting on the issue of gambling on options, Obaiyathullah maintained that the argument profits from options are “unearned” is an invalid argument. It ignores the fact that both the buyer and seller take on risk and that the buyer has at stake the premium he has paid. Furthermore, the change on an option's value arises from changes in the underlying asset value and not by chance. If such gain is unearned, then it implies that all capital gain income could also be considered unearned. The second argument that options involve *gharar* since there is potential for default totally ignores the fact that Exchanges place margin requirements on sellers of options precisely to prevent default. Notes that buyers of options would by definition not default because

³⁷ Ahmad Abdel Fattah El-Ashkar, “Toward An Islamic Stock Exchange in a Transitional Stage”, *Islamic Economic Studies*, vol. 3, no. 1, December 1995, pp. 82–83.

their maximum possible losses is the premium, all of which is fully paid for at the time of purchase.³⁸

In addition, Abū Ghudah as *Shari'ah* adviser of one of the leading Islamic financial institution, namely Dallah al-Barakah Group maintained that looking for price differential by buying some beneficial assets, then selling them before getting their associated profit or after that, is a legitimate and legal objective; because it is a trade aiming at selling what one has bought at higher price. However, some contemporary Muslim jurists, as Abū Ghudah notes, are of the opinion that buying and selling shares with the intention of getting the price differential is a kind of transaction on currencies, given the short period between the sale and purchase offers, and there is no value added from such a transaction except the objective of looking for price differential. Such an argument, as Abū Ghudah argues, ignores the nature of a share, which is part of whole asset of the company, which shall be sold at higher price than the price of purchase.

In fact, trading shares with the objective of getting price differential is not without benefits. It helps in stimulating the economic activities whether it is a bilateral or a collective transaction. However, these benefits could not be appreciated unless we look into the different activities, preceding or following the purchase. Thus, the price given by the buyer of these shares allows the seller to embark in new forms of commercial activities such buying shares from another companies and in turn, creating liquidity in the market, which will benefit the participants in the market in different forms. If this liquidity is impossible in a market, investors may not have taken the risk of locking their money in the shares of these companies. Thus, investors are free to go in or out at any time and, each move has its causes and objectives. This is similar to what is reported from the prophet to have said: "let people benefit from each other".³⁹

The fear from the harm which will be created by this rapid form of transaction or the problems that had happened in certain countries, under certain circumstances were the result of negligence of the *shari'ah* regulation in shares trading. Companies are trading in futures while they are still in the stage of formation just after the collection of money for

³⁸ See, Obiyathulla Ismath Bacha, "Derivatives Instrument And Islamic Finance: Some Thoughts for Reconsideration", p. 14.

³⁹ *Ṣaḥīḥ Al-Bukhārī with Fath al-Bārī*, vol. 4, p. 372.

subscription or such companies are still trading while in reality they are floating of debt or practising selling short.

On the other hand, the argument that this form of rapid trading is only created by the spread of false information, political event, publication of economic expectation and so on, have also its effect to individual business without affecting its legal status. Moreover, the investor who is selling his shares may want to avoid or minimize an imminent loss when the shares prices of the company start declining and with the possibility of decline further. Then, where is the evidence from *shari'ah*, that will prevent him from getting rid of these shares if the exchange is done according to *shari'ah* regulations without manipulation, cheating or *gharar*?⁴⁰ Thus, it is clear that the claim that options trading is a kind of gambling is unfounded.

Given the simplistic approach taken by some of the participants in the discussion on the relationship, if any, between options and gambling, a general remark regarding the methodology adopted by the Islamic Fiqh Academy in formulating Islamic law, so far, is necessary.

It should be noted that a comprehensive development of Islamic finance in general or the admission of certain types of derivatives instruments is almost impossible without the cooperation of the Islamic Fiqh Academy which is the most influential institution in formulating the rules of Islamic law related to commercial activities. Although the Academy had done valuable contributions in this direction so far, however, several remarks need to be made here.

Firstly there is a tendency to stop the discussion as soon as the time allocated for the discussion of a specific issue expired saying that "may Allāh gives his blessing to what have already been discussed"!!!⁴¹ This was for instance, the argument of the chairman during the discussion about futures contracts. Despite the fact that some of the participants have proposed the postponement of the resolution on the issue because some of the issues have only been clarified through the discussion and not through the papers presented. Indeed an expedited resolution may not be immune from some shortcomings.

Secondly, many participants at the Academy forums opposed the discussion of any issue upon which there is already a decision from

⁴⁰ For more detail see, 'Abd al-Sattār Abū Ghuddah, "al-Istithmār fi al-Ashum wa al-Wihdāt al-Istithmāriyyah", *Majallat Majma' al-Fiqh al-Islāmī*, pp. 112-115.

⁴¹ See for instance, *Majallat Majma' al-Fiqh al-Islāmī*, no. 7, vol. 1, p. 650.

the Academy.⁴² For example, certain participants objected to discuss the issue of reselling *salam* prior to taking possession that was raised by other participants during the discussion about *'uqūd al-munāqaṣāt*. It was argued that there is no reason for raising the difference of opinions in such an issue since a previous resolution of the Academy maintained that that it is illegal to resell *salam* prior to taking possession.⁴³

Indeed it is impossible to continue repeating the same thing about a single issue. However, if a person has new ideas or if he discovered some shortcomings in the previous resolution, or he is not one of the participants in the discussion, where the prohibitive resolution was taken, he shall be given the opportunity to articulate his point. The resolutions of the Academy are just *ijtihādī* ruling and an *ijtihād* could be reversed whenever new evidence appears especially in these issues affecting not only individuals or countries but the whole Muslim *Ummah*.

Finally, it is imperative to increase the number of economists associated with the Academy in order to give participants clear understating of the issue discussed and to explain its economic impact to the Muslim economies. For instance, the main purpose of derivatives instruments is risk management. However, the issue has not been emphasized by the papers presented or highlighted during the discussion while the admission of a specific contract into Islamic law will not depend only on its contractual form but also its objectives and the benefits behind. Yet, at present there are some Muslim economists helping the Academy and they deserve to be thanks for their effort, but given the fact that the resolutions of the Academy are affecting the whole Muslim *Ummah* a wider consultation is needed.

The present study will address the above possibility by studying the possible Islamic alternatives: how they could be devised to be tools of risk management and how some necessary modifications can be implemented. The first possible Islamic alternative to conventional options is *khiyār al-sharṭ* and its variation *khiyār al-naqd*. However, major problems may arise here especially with the issue of taking money in exchange for giving the option and is it possible to trade the option as a separate entity from the underlying asset? Moreover, if any change in *khiyār al-sharṭ* and *khiyār al-naqd* is not possible, could these contracts be expected to achieve the benefits of conventional options? There is a

⁴² See for instance, *Majallat Majma' al-Fiqh al-Islāmī*, no. 9, vol. 2, p. 163.

⁴³ See, *Majallat Majma' al-Fiqh al-Islāmī*, no. 9, vol. 2, p. 334.

conflicting analysis on these matters, some time, aggravated by some degree of misunderstanding of the major legal issues in conventional options on the one hand, and a narrow interpretation of the concept of *khiyār al-sharṭ* and *khiyār al-naqd* on the other.

The second possible Islamic alternative is *bay' al-'arbūn*. The possibility of an Islamic alternative is more promising here than it is with *khiyār al-sharṭ* and *khiyār al-naqd*. Thus, despite the general objection of some Muslim jurists to creating an Islamically acceptable form of option contract based on *'arbūn*, some Muslim economists have already acknowledged that the general form of *'arbūn* could serve as an alternative to a call option. Moreover, a reversed *'arbūn* could also serve as a put option as it will be elaborated later. However, for lack of genuine and detailed legal discussion about this possibility, Muslim economists have not made sufficient effort to exploit it. On the other hand, if *'arbūn* is proposed to serve as an alternative to conventional options, is it possible to use it in commodities, shares, currencies trading, or in *murābaḥah* and *salam* for instance, as a tool of risk management?

The issue of giving a premium in exchange for the right to options as separate contract besides the price in exchange for the underlying asset is one of the most commonly raised problems concerning options. It is maintained that the subject matter in such a transaction is a pure right or *ḥaq mujarrad*, which is not considered as property by many scholars, and therefore, it cannot be the subject matter of a contract. However, a thorough investigation shows that the majority of early Muslim scholars consider a right as a property although the vast majority of contemporary jurists prefer the opinion of the Ḥanafis, may be, on grounds of *taqlīd*.

Moreover, the importance of the issue lies in the fact that even if *khiyār al-sharṭ* and *khiyār al-naqd* on the one hand, and *'arbūn* on the other, have been accepted as the Islamic alternative to conventional options, their use will be limited to the primary market. To extend this possibility to the secondary market requires the sale of an option as a separate entity, which is not possible if a right cannot be the subject matter of contract. One major study which addressed the issue of a right as a property in connection with options and passed a negative judgment, is the study conducted by the Islamic *Fiqh* Academy, which is by no means a convincing study, as we shall see. Yet, some other studies have already endorsed the legality of selling a pure right like that in conventional options based on the theory of freedom of contract, but it seems that more evidence and elaboration are needed to rebut the

different arguments against the sale of a pure right. Thus, the issue of a right as a property needs a detailed investigation.

An investigation about options from an Islamic point of view would not be complete unless the issue of gambling in options and the claim that options trading is illegal because it involves the combination of two contracts in one transaction is tackled. Thus, in the following pages the present study elaborates on these issues and assesses the possibility of options trading in Islamic law and finance.

CHAPTER NINE

KHIYĀR AL-SHART, RISK MANAGEMENT AND OPTIONS

The first Islamic alternative to conventional options advanced by modern Muslim jurists is *khiyār al-shart* or option of stipulation. Among those who have drawn an analogy between the two concepts and concluded that conventional options could be accommodated in Islamic law through *khiyār al-shart* are Kamālī,¹ Youssouf Sulaimān,² ‘Ali Abd al-Qādir,³ Shahhāt al-Jundī,⁴ and Obaidullah.⁵

Meanwhile, some other scholars have made an analogy between the two concepts but concluded that there are no grounds for legalizing options by making an analogy to *khiyār al-shart* or option of stipulation. Yet, the theory of contract in Islamic law has discussed the notion of option within the framework of giving the contracting parties a right whether to confirm the contract or to cancel it within a determined period. Thus, around thirty-three different types of options with varying degrees of importance have been identified in Islamic law.⁶ However, of these various kind of options, the one that is potentially promising in designing new financial instruments is *khiyār al-shart* or the option of stipulation and its variant or subdivision, namely *khiyār al-naqd* or the option of paying the price as an indicator of the confirmation of the contract.

Although the possibility of designing new instruments as an alternative to the conventional options has been addressed to some extent by

¹ *Islamic Commercial Law: An Analysis of Futures and Options* (unpublished Manuscript), Law Center International Islamic University.

² “Rai’ al-Tashri’ al-Islāmī fi Masā’il al-Burṣah”, *al-Mawsūa’ al-‘Ilmiyyah wa al-‘Amaliyyah lil bunūk al-Islāmiyyah*, Cairo, al-Ittihād al-Dawli lil-Bunūk al-Islāmiyyah, 1982, vol. 5, pp. 428–445.

³ Ta’qīb ‘alā Rai’ al-Tashri’ al-Islāmī fi Masā’il al-Burṣah”, *al-Mawsūa’ al-‘Ilmiyyah wa al-‘Amaliyyah li a-bunūk al-Islāmiyyah*, Cairo, al-Ittihād al-Dawli lil-Bunūk al-Islāmiyyah, 1982, vol. 5, pp. 438–443.

⁴ *Mu’āmalāt al-Burṣah fi al-sharī‘ah al-Islāmiyyah*, Cairo, Dār al-Nahdah, 1988.

⁵ “Financial Engineering with Islamic Options”, *Islamic Economic Studies*, vol. 6, no. 1, November 1998, pp. 73–103.

⁶ See Abū Ghuddah, *al-Khiyār wa’Atharuhu fi al-‘Uqūd*, Dallah al-Barakah, Jeddah, n.d.

some scholars before, the introduction of the option of paying the price or *khiyār al-naqd* will add a new dimension to the possibility of risk management through the theory of *khiyārāt* in Islamic law. Hence, we discuss the legal aspect of these contracts and the possibility of using them as an alternative to the conventional options.

Concept of Khiyār Al-Sharṭ

Khiyār al-sharṭ is an option in the nature of a condition stipulated in the contract whether to confirm the contract or to cancel it in a specific period.⁷ It provides a right to either of the parties, or both or even to a third party to confirm or to cancel the contract within a stipulated period of time.⁸

The basic validity of *khiyār al-sharṭ* is proven by the authority of a *ḥadīth* in which it is reported that Ḥibbān Ibn Munqidh complained to the Prophet that he was the victim of frequent cheating in sale. The Prophet responded, "When you concluded a sale, you may say there must be no fraud and you reserve for yourself an option lasting for three days"⁹ It is also asserted by the *ḥadīth* of 'Abd Allāh Ibn 'Umar to the effect that "the parties to a contract of sale have a right of option as long as they are not separated except in a sale that is subject to option."¹⁰ Another general *ḥadīth* is also cited in this regard. "Muslims are bound by their stipulation unless it be a stipulation which declares unlawful what is lawful or permits what is unlawful". Besides the above *ḥadīths*, some scholars have even reported *ijmā'* as a proof of the validity of *khiyār al-sharṭ*. Al-Nawawī, for instance, said in this regard "The strongest basis for *khiyār al-sharṭ* is *ijmā'* ... and it is enough"¹¹ A similar statement has been recorded by Ibn al-Humām.¹²

However, Ibn Rushd has reported the disagreement of al-Thawrī, Ibn Shubrumah and some of the Zūhirī school especially Ibn Ḥazm who has advanced several arguments to back his claim. However, one

⁷ Ibid., p. 194.

⁸ 'Abd al-Rahmān al-Jizārī, *al-Fiqh 'alā al-Madhāhib al-'Arb'ah*, Dār al-Rayyān li al-Turāth, Cairo, n.d., vol. 3, p. 155.

⁹ *Sahīh Al-Bukhārī with Fatḥ al-Bārī*, vol. 4, p. 337; *Sahīh Muslim with Sharḥ al-Nawawī*, vol. 10, p. 177.

¹⁰ *Sahīh Al-Bukhārī with Fatḥ al-Bārī*, vol. 4, p. 326.

¹¹ Al-Nawawī, *al-Majmū' Sharḥ al-Muhazzab*, vol. 9, p. 225.

¹² Ibn al-Humām, *Fatḥ al-Qadīr*, vol. 5, p. 111.

may say perhaps there was a little disagreement among scholars at the beginning on *khiyār al-sharṭ* but has been accepted by *ijmāʿ*. What is important here in relation to our discussion is that the legality of *khiyār al-sharṭ* is not a point of contention among Muslim jurists nowadays. It is worth mentioning that the option of stipulation is only valid with regard to non-usurious sales. In addition, *khiyār al-sharṭ* is not applicable to *salam*, and any option would make the contract of *salam* null and void according to the majority. The Mālikīs allow such an option if the period is very limited based on their opinion that the price in *salam* could be deferred for three days after a mutual consent and even longer if it has not been the subject of mutual consent during the conclusion of the contract. As for usurious items such as currencies and barter sale of foodstuffs, they must be concluded on the spot without delay. Therefore, *khiyār al-sharṭ* is not applicable to currency trading. Yet, some Muslim scholars have attempted to assign it to the modern paper currency, the same rule of *fulūs* as discussed by early scholars and where some scholars have allowed *khiyār al-sharṭ* in *fulūs*, maintaining that as they are not currency they are not usurious. However, we have already demonstrated the weakness of this opinion and the discrepancy of the analogy of considering paper money as a kind *fulūs* while discussing the possibility of trading gold on a forward basis. Therefore, *khiyār al-sharṭ* has no place in currency trading in all circumstances.

The Terms of Khiyār Al-Sharṭ

There are three main opinions on the matter. Abū Ḥanīfah, Zufar and the Shāfiʿi held that the option should not exceed three days as it is specified in the *ḥadīth*, because *khiyār al-sharṭ* is allowed contrary to the norms of *qiyās* as an exception. Therefore, no liberal recourse to it should be allowed. In other words, *khiyār al-sharṭ* is initially against the objective of sale, which should be binding immediately after its conclusion, but the shariʿah allowed it on the basis of necessity. Therefore, it should be limited to the minimum possible period, which is three days.¹³

The Mālikīs, on the other hand, have taken a more flexible stance toward the understanding of the *ḥadīth*, saying that the *ḥadīth* men-

¹³ al-Kasānī, *Badāʾiʾ al-Sanāʾiʾ*, vol. 5, p. 157; Ibn ʿAbidin, *Radd al-Muhtār*, vol. 4, p. 565. Al-Nawawī, *al-Majmūʾ Sharh al-Muhazzab*, vol. 9, p. 190.

tions three days in a figurative sense merely to convey the concept in an illustrated manner. The actual duration of an option may thus be determined by relating the option to the subject matter of sale. Thus, the option period of three days may be deemed adequate for the sale of cloth, for instance, but it may be extended to a month in the case of buying a house.¹⁴

The third opinion is that of the Ḥanbali school and the two disciples of Abū Ḥanīfah, namely Abū Youssuf and Muhammad Ibn al-Ḥassan al-Shaibānī. They held that the option may be for any length of time and that is entirely a matter of agreement between the contracting parties and there is no maximum permissible period.¹⁵

However, what still hinders for the development of new instruments based on *khiyār al-sharṭ* is the claim that the legality of this *khiyār* is endorsed by way of exception to the general principles and therefore, it is not possible to make it the basis of an analogy. We have already alluded to the deficiency and problematic nature of such assertion inappropriateness of endorsing the legal maxim that what has been accepted by way of exception to the general norms of *qiyās* could not be the basis for another analogy in our discussion about the legality of *salam*. However, some modern writers preferred the opinion that the period of *khiyār al-sharṭ* should not exceed three days as it is stated in the *ḥadīth* because it has been legalized by way of exception and not in line with the general principles. Therefore, it should not be used as an alternative to the conventional options, which are generally for one month to twelve months. Moreover, it is claimed that the period of option in the conventional system is generally used for speculative purposes and therefore, there is no need therefore, for it in the Islamic financial system. Hence, the period of option should not exceed three days and there is no need to change this rule, which has in any case been validated by way of exception.¹⁶

However, it could be argued that to stick to the literal meaning of the *ḥadīth* without any effort to analyze its purpose is not the best approach of genuine Islamic research especially in the area of *muʿāmalāt* and when we are addressing new types of contracts unknown to early Muslim jurists. Moreover, the majority of these scholars have opted

¹⁴ Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 208.

¹⁵ Ibn Qudāmah, *al-Mughnī*, vol. 3, p. 585; Ibn ʿĀbidīn, *Radd al-Muhtār*, vol. 4, p. 565.

¹⁶ Samir Riḍwān, *ʿAswāq al-Awrāq al-Māliyyah*, p. 367.

for the extension of this period according to the commodity sold or according to the need of the contracting parties as it is explained above. It seems that there is a tendency among certain writers to judge any new transaction, as illegal, as it is the best way of a valuable piece of research or the only indication of the genuine Islamisity of a study and the *taqwā* or God fearing of the writer. Moreover, in order to reach this negative conclusion, no effort would be required made to analyze each part of the problem separately but all the issues that could be and could not be accommodated in Islamic law, and those which, are mixed in order to give a negative impression. However, as it is rightly stated by Sufyān al-Thawrī that “the genuine *fiqh* interpretation is that which is done by a reliable jurist to prove the legality of an uneasy alternative without contravening the principles of the *sharī'ah* while the strictness (by prohibiting every thing) could be done by everyone”.¹⁷

Thus, the second opinion regarding the time period of *khiyār al-sharṭ* and especially the third opinion are more in line with the objectives of the *sharī'ah* and would be preferred by the present study since there is no single piece of evidence which proves that the legality of *khiyār al-sharṭ* is based on an exception.

Ownership of Commodity During the Period of Khiyār and Liability for Damage

The ownership of the commodity during the period of the option of stipulation has given rise to difference of opinions among the different schools of Islamic law. The major positions of these schools will be briefly highlighted.

The Ḥanafīs are of the opinion that if both parties, namely the buyer and seller, hold the option, there would be no change in the ownership of the countervalues and if the commodity is destroyed before taking possession, the seller would be held liable. But if it is destroyed after the buyer takes possession, the contract would be cancelled and the buyer would be held liable and he is required to pay the value of the destroyed commodity. However, if the buyer holds the option and

¹⁷ Qaraḍāwī, *Bay' al-Murābahah li al-'Āmir bi al-Shirā' Kamā Tujīh al-Maṣārīf al-Islāmiyyah Dirāsah fi Daw' al-Nuṣūṣ wa al-Qawā'id al-Shariyyah* Maktabat Wahbah, Cairo, 1987, p. 23.

the commodity is destroyed before taking possession, he would be held liable to pay the price and not the value.¹⁸

The Mālikis, on the other hand, assert that the ownership of the article of exchange does not shift during the option period irrespective of who holds the option. The confirmation of the contract transfers the ownership to the buyer. When the seller holds the option, and the buyer takes possession of the article and subsequently claims loss of the commodity, the issue will be resolved by legal process. In principle, the seller should be liable for all damages to the commodity during the period of *khiyār* unless there is a case of negligence on the part of the buyer, because the buyer before taking possession is considered as a trustee. Thus if the buyer claims the loss of the commodity two situations may arise: if it is possible to keep it safe without being destroyed such as in the case of cloth or jewelery, he should bring evidence to substantiate his claim of loss. Otherwise, he will be held liable.

On the other hand, if the commodity could not be kept secret as in the case of animals and the buyer claimed its loss after taking possession and some people give testimony contradicting his claim, then he will be held liable. However, if there is no testimony as in the above case, he should take an oath that he has not been negligent. If he refuses to take the oath, he should be held liable. The Mālikis' main argument is that since the contract is not binding then it should not have effect and the ownership of the commodity should remain with the seller.¹⁹

The Ḥanbalis maintain that ownership of the commodity transfers to the buyer during the option period irrespective of whether the option is with the buyer or the seller or both. In case the commodity is destroyed or suffers a diminution in value during the option period, the liability of the buyer and seller depend on whether or not the commodity is characterised by weight measurement or number. If it is of this kind and the buyer has taken possession, he should be held liable in case of destruction. But if he did not take possession, then, the seller would be liable. However, if the commodity does not possess the above characteristics, the buyer would be held liable whether he has taken possession or not, except in the case where he wanted to take possession but has

¹⁸ See, al-Kāsāni, *Badāi' al-Sanāi'*, vol. 5, p. 264; Ibn al-Humām, *Fath al-Qadīr*, vol. 5, p. 504.

¹⁹ See, Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 211; al-Dasūqī, *Sharḥ al-Dasūqī 'alā al-Sharḥ al-Kabīr*, vol. 3, p. 103; Ibn Juzai, *al-Qawānīn al-Fiqhiyyah*, p. 264.

been prevented by the seller. In such a case, the buyer would be held responsible.²⁰

The Shāfi'i have held that if the seller initiates the option, his ownership of the commodity will continue. If the buyer retains the option, the ownership of the commodity transfers to him because the contract is binding from the seller's side. And if both have stipulated the option, the ownership of the commodity remains suspended during the time of the option. If the commodity is destroyed before being transferred by the seller to the buyer, the contract is considered annulled whether the option is with the buyer, the seller or both. Similarly, if the destruction occurs after the buyer has taken possession, the contract would be annulled if the seller holds the option.²¹

Although the opinion of some of the schools seems to be more comprehensible than the opinion of others with regard to the above issue, the whole interpretation is based on *ijtihād* and not on clear text. Therefore, it seems that the preference of any opinion, or of any school, will depend on its practical flexibility and the consent of the parties concerned. This wide range of opinions could also be a source of flexibility for those willing to design new instruments based on *khiyār al-sharṭ*.

Managing Price Risk with Khiyār Al-Sharṭ

The importance of risk management in the present day business environment is undeniable. A factor which significantly contributes to risk is price volatility. *Khiyār al-sharṭ* could be used for managing business risk and specifically price risk in the context of commodity markets.

As far as the financing of long-term assets, such as land, building plant and machinery are concerned *murābaḥah* and *ijārah* seem to be the most popular modes of financing with Islamic banks. Under *murābaḥah* financing, the Islamic bank purchases an asset according to the specification of its client from the supplier and resells it to his client at a higher price, often on deferred basis. The process involves a risk that is subsequent to purchase by the Islamic bank from the original supplier; it may not be in the interest of the client any longer to buy

²⁰ See, Ibn Qudāmah, *al-Mughnī ma' al-Sharḥ al-Kabīr*, vol. 4, p. 219; al-Buhūti, *Kashshāf al-Qinā'*, vol. 3, p. 206; 'Abd al-Rahmān al-Jizārī, *al-Fiqh 'alā al-Madhāhib al-'Arba'ah*, vol. 3, p. 171.

²¹ See, al-Nawawī, *al-Majmū'*, vol. 9, p. 214.

the same asset from the bank. Especially if the *murābahah* between the bank and the customer is not binding.

It can be easily shown that management of the above risk is possible through *khiyār al-sharṭ*. In this case, a simple alternative for the Islamic bank would be to retain an option for itself at the time of purchase from the original supplier. Subsequently, if the client buys the asset as promised, the option would automatically expire and the earlier contract becomes binding. However, if the client fails to honor its commitment, the Islamic bank would be in a position to exercise its option and rescind the purchase contract.

Thus, *khiyār al-sharṭ* enables the Islamic bank to shift the above risk to its original supplier. It is also quite realistic that the Islamic bank may have to forgo a part of its profit since the original supplier may charge a high price in case of the sale with option as compared to sale without option. This is legally and ethically justifiable since the original supplier is now exposed to greater risk.²²

Similarly, it is not difficult to see the usefulness of *khiyār al-sharṭ* for managing risk in the financial market, such as the stock market which is characterised by volatile prices. The economic rationale of the conventional options is believed to be their potential use as a hedging or risk management device. For instance, individual A plans to buy or sell stock X after a time period of three months. He may be adversely affected if the price moves up or down during this time period. The risk due to price movement could be hedged by purchasing a call (put) with a given exercise price of, say, \$50. The price paid for the option; say \$5 is in the nature of insuring against adverse price fluctuations. At the end of three months even if the price moves up to \$60 (down to \$40), individual A is not affected since he can buy or sell at the exercise price of \$50. While this is true, the fact remains that this contract can be used for speculation.

An alternative scenario can be achieved through *khiyār al-sharṭ*. Individual A can now enter into a purchase or sale contract and stipulate a condition of option for himself for a period of three months. At the end of the three months, if the price of stock X moves up or down, it can confirm the contract of purchase or sale at the known contractual

²² See, Obaidullah, "Financial Engineering with Islamic Options", *Islamic Economic Studies*, vol. 6, no. 1, November 1998, pp. 90–91. Islamic Development Bank; Al-Ashqar, "*khiyār al-sharṭ*", p. 43.

price and thus be immune to price risk. However, if the price of stock X moves down or up then individual A can rescind the contract and purchase (sell) in the market, thereby not losing the profit potential. Thus, *khiyār al-sharṭ* may benefit the party holding the option at the cost of the counterparty. However, the disadvantage caused to the counterparty can be compensated in the form of a higher contractual price and need not be paid separately upfront to the counterparty. It is this feature that provides an effective curb to speculation on price differences and thus, differentiates Islamic options from conventional ones.²³

Despite the fact that the above alternative could be considered as a genuine Islamic way of risk management, to consider it immune from price differential and, by consequence free from the possibility of being used for speculation is not totally true. The individual, who is buying stock, as it is mentioned in the above example, is looking at the up or down trend of the stock he has bought or sold. He is neither looking to avoid possible cheating in the price from his counterpart nor a possible defect in the commodity or stock he bought or sold. At the same time, he is not asking for an option because he has no sufficient knowledge of the subject matter he has agreed to buy. He is buying these stocks with a view of seeing if the later price is in his favor in which case he will exercise the option in order to benefit from price differential and if the opposite situation happens he will leave the option to expire without exercising it. Yet, we are not arguing that since the use of *khiyār al-sharṭ* as it is in the above example is not immune from being used for price differential gain, therefore, it should be declared illegal. On the contrary, we would like to say the issue of price differential should not be used as ground to ban certain transactions. Otherwise even the use of *khiyār al-sharṭ* here would be the center of controversy since it is not free from the intention of gaining from price differentials.

In the case of *ijārah* financing too, some risk factors can be easily avoided or shared with *khiyār al-sharṭ*. One common risk inherent in *ijārah* financing is the risk of finding an alternative use of the asset, as well as of locating a new client where the lease period is shorter than the economic life of the asset. This is also the risk of the asset obsolete and the uncertainty about the realisation of salvage value in the absence of an

²³ Obaidullah, "Financial Engineering with Islamic Options", pp. 91–92.

active secondary market for the assets. This risk can be shared between the Islamic bank and the lessee by providing an option to either or both parties to confirm or rescind the contract after a certain period.

Although *khiyār al-sharṭ* even without any monetary compensation in exchange for giving the right to cancel or confirm the contract, can be a useful tool of risk management, some scholars have discussed the possibility of charging a fee or premium for the option in *khiyār al-sharṭ* so as to match the conventional option.

Kamālī has thus, maintained that the validity of charging a fee for options is a matter that falls under the general subject of contractual stipulation, a subject that invoked different responses from the schools of Islamic law notwithstanding the affirmative nature of the source of evidence on it. In principle, the contractual stipulation by the parties should not be allowed to circumvent and override the given mandate of the *sharī'ah* in contract. In other words, the parties are not at total liberty to stipulate what they please. The liberty given by the general theory of freedom of contract in Islamic law is subject to the condition that stipulation should not overrule the clear injunctions of Islamic law. Provided that this limitation is observed, there is in principle no restriction on the nature and types of stipulations that the parties may wish to insert into a contract.

According to Ḥanafīs and Shāfīs' point of view stipulations are valid when they are in line with the essence of the contract. Thus, a condition to provide a guarantor or a surety in the form of mortgage or pawn is legal provided that both parties agree upon it. The Mālikīs are even more explicit in validating stipulations having financial value, as for example a buyer's stipulation for transporting the goods to a certain locality. The Ḥanbalīs are the most liberal. They maintain that stipulations which fulfill a legitimate objective and realise a benefit and convenience, or which may help to remove hardship and facilitate the easy flow of commercial transactions are generally valid as a matter of principle.²⁴

Thus, after elaborating on the opinion of the different schools on the liberty of the parties involved in a contract to insert the conditions they wish, Kamālī concluded that this analysis is not only affirmative of the parties' freedom to insert stipulations in contracts but also that compensation or a fee may be asked by one who grants an option or

²⁴ For more details, see Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, pp. 352–356.

privilege to the other. If the seller is entitled to stipulate a security deposit or pawn, then, it is a mere extension of the same logic that he may charge the buyer and impose a fee for compensation in respect of such options and stipulations that are to the latter's advantage. When the buyer, for example, stipulates that he will ratify or revoke the contract within a week or a month, this may well prove to be costly to the seller and he may, therefore, charge a fee/compensation for granting the option. We thus conclude that options may carry a premium and there should basically be no objection to this.²⁵

A similar approach has been taken by other Muslim jurists, such as, Shaḥḥāt al-Jundi, Yousuf Sulaimān and 'Ali 'Abd al-Qādir. Yousuf Sulaimān, for instance, concluded: "the money taken by the seller as premium could not be returned to the buyer (if he fails to ratify the contract within the agreed period) because Allāh says, "Oh you who believe fulfill your obligations".²⁶ In addition according to the reported *ḥadīth* of the Prophet "Ṣulḥ among Muslim is permissible unless it transforms what is *ḥalāl* into *ḥarām* or what is *ḥarām* into *ḥalāl* and, Muslims are bound by their stipulations unless it be a stipulation, which declares unlawful what is permissible or permits what is unlawful".²⁷ Since the second party has the same right, then he could sell it as well given that the time period of the option is determined. On the other hand, it is possible that one of the parties donated the premium to the other as a gift.²⁸ Similarly, 'Ali 'Abd al-Qādir²⁹ and Shaḥḥāt al-Jundi³⁰ endorsed the above opinion.

In contrast, Ahmad Muḥyī al-Dīn and Samīr Ridwān have taken a negative position and totally opposed any adoption of conventional options through *khiyār al-sharṭ*. One of their main arguments is that *khiyār al-sharṭ* or the option of stipulation is anomalous to norms and principle of Islamic law. It is merely tolerated by way of exception. It is not allowed to give an opportunity to look if the price movement is in

²⁵ Ibid., pp. 356–357.

²⁶ Al-Mā'idah (5/1).

²⁷ Al-Bukhārī, *Saḥīḥ al-Bukhārī with Faṭḥ al-Bārī*, Book of conditions (Shurūṭ), v. 5, p. 354.

²⁸ See, Youssuf Sulaimān, "Rai' al-Tashrī' al-Islāmī fi Masā'il al-Burṣah", *al-Mawsū'ah al-'Ilmiyyah wa al-'Amaliyyah lil bunūk al-Islāmiyyah*, vol. 5, p. 425.

²⁹ See, "Ta'qīb 'alā Rai' al-Tashrī' al-Islāmī fi Masā'il al-Burṣah", *al-Mawsū'ah al-'Ilmiyyah wa al-'Amaliyyah lil bunūk al-Islāmiyyah*, vol. 5, p. 441.

³⁰ See, *Mu'amalāt al-Burṣah*, p. 151.

one's favor.³¹ We have already demonstrated the weakness of this argument while mentioning the legality of *salam*. Similarly, Ibn Taymiyyah and Ibn Qayyim vigorously refuted this claim with *khiyār al-sharṭ* and maintained that it is allowed as a matter of principle and not against the norms or *qiyās*. Yet, it could be argued that it is wise to prefer the opinion of the majority rather than to follow the opinion of a few scholars. However, such an argument will not emanate from a person who has little knowledge about Islamic law. What should be followed is the strength of evidence advanced and the spirit and objectives of the *sharī'ah*.

Moreover, the Ḥanafis themselves have departed from the principles that they have established with regard to this theory in general and about *khiyār al-sharṭ* in particular by legalising *khiyār al-naqd* by way of analogy to *khiyār al-sharṭ*. Yet, if *khiyār al-sharṭ* is allowed by way of exception as it is claimed and, if the alleged theory, that, what has been allowed by way of exception should not be the basis of analogy (*ma thabata 'alā khilāf al-qiyās la yuqāsu 'alaihi*), is true, then *khiyār al-naqd* should be declared illegal in the Ḥanafī school. But this was not the case. Thus, we do believe that *khiyār al-sharṭ* is in line with the norms of *qiyās* and it is legal to base an analogy on it.

On the other hand, the critics objected to option on the grounds that it is an unfair transaction and works for the advantage of one party to the total detriment of the other, and therefore, it is a kind of oppression and injustice.³²

Refuting this argument, Kamālī said:

This analysis is somewhat unfounded and superfluous as it is based on wrong foundation. For one thing, it should be obvious that the option holder does not always make profits, as Ḥassan tends to suggest, but may make a loss and lose his premium as a result. It is not as if the option holder has locked himself in a no lose situation and Ḥassan has not acknowledged this. The other point is that the option holder may well be acting as a hedger who wishes to protect himself against exorbitant losses and buying options merely tries to minimize the prospect of a bigger loss. And then the issue of oppression and injustice is rather an exaggeration simply because the parties enter an agreement and the option buyer pays for the advantage he is granted. The price that he pays is also determined

³¹ Ahmad Muḥyī al-Dīn Ḥassan, *Amal Sharikāt al-Istithmār*, pp. 268–271; Samīr Riḍwān, *Sūq al-'Awrāq al-Māliyyah*, p. 361.

³² Ahmad Muḥyī al-Dīn Ḥassan, *Amal Sharikāt al-Istithmār*, pp. 268–271; Samīr Riḍwān, *Sūq al-'Awrāq al-Māliyyah*, p. 361.

not by him or his agent, but by the exchange authorities and the question of manipulation and unfair advantage is basically not relevant.³³

So, it is clear that *khiyār al-sharṭ* could serve as a tool of risk management and fulfill some of the benefits associated with conventional options. Moreover, if we consider the possibility of charging a fee for giving the option, the benefits of *khiyār al-sharṭ*, as a tool of risk management, may be parallel to those of conventional options.

However, some have objected to such a proposition on the grounds that the subject matter in such a transaction will be a pure right, which is not eligible to be the subject matter of a contract. However, the present study will elaborate on the issue and critically analyze the different opinions in a separate chapter.

Khiyār Al-Naqd

It is the right of either of the parties to confirm the contract or to cancel it by means of the payment of the price. In other words, it is the conclusion of a contract with the option that the payment of the price, within a specific period, would confirm the contract while a failure to do so would get cancelled.³⁴

Given the fact that the seller or the buyer can stipulate *khiyār al-naqd* and the legality of the two contracts namely *khiyār al-sharṭ* and *khiyār al-naqd* is discussed separately in the classical jurists works, it is worthwhile to discuss the two contracts separately here as well. Thus, first case the seller say to the buyer, "I am selling to you this commodity on the condition that if you do not pay me the price within a specific period of time (one month for instance), there is no sale".³⁵ In second case the seller says to the buyer after receiving the price, "I sell to you this item on the condition that if I return to you the price within a specific period (one month for instance), there is no sale between us."³⁶ The first case is very similar to *khiyār al-sharṭ* while the second is a variation of

³³ Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, p. 360.

³⁴ See *al-Dur al-Mukhtār Sharh Tanwīr al-Abṣār*, vol. 4, p. 571; 'Abū Ghuddah, *al-Khiyār wa' Atharuhu fī al-'Uqūd*, p. 43.

³⁵ al-Zaila'ī, *Tabyīn al-Ḥaqā'iq sharh Kanz al-Ḥaqā'iq*, Dār al-Ma'rifah, Beirut, vol. 4, p. 15.

³⁶ Ibn 'Abidīn, *Rad al-Muhtār' alā al-Dur al-Mukhtār*, Dār al-Fikr, Beirut, 1979, vol. 4, p. 567.

bay' al-wafā'. Therefore, the legality of the first case is generally agreed upon while Muslim jurists, depending on their admission or rejection of *bay' al-wafā'*, disputed the legality of the second.

Although the first case is very similar to *khiyār al-sharṭ*, its admission by way of analogy to *khiyār al-sharṭ* is another evidence that the validity of *khiyār al-sharṭ* is in line with the norms of *qiyās* and therefore, any analogy to *khiyār al-sharṭ* is permissible. Moreover, this *ijtihād* by the Ḥanafīs may constitute a precedent for those involved in Islamic commercial law to design any contract based on analogy to *khiyār al-sharṭ*, provided it could achieve something in the process of designing new instruments.

The possible use of *khiyār al-naqd* as a means of risk management as it is discussed in the first case is almost similar to that of *khiyār al-sharṭ*. Thus, some of the contemporary studies, which have discussed *khiyār al-naqd* advanced almost the same practical cases as the ones discussed in *khiyār al-sharṭ*.³⁷

The second aspect of *khiyār al-naqd* is a form of *bay' al-wafā'*. It is when the seller says to the buyer "I will sell you this item on the condition that whenever I return to you the money that you have paid, you have to return to me my item". This kind of sale has been the source of disagreement between Muslim scholars. The Mālikīs, Shāf'īs and Ḥanbalīs consider it as an illegal contract because it will be a kind of a loan given in return for a specific benefit (*qarḍan Jarra naf'an*), which is forbidden, while the Ḥanafīs allowed it.

Thus, if we uphold the Ḥanafīs' position in the second case of *khiyār al-naqd*, the practical aspect might be represented by the following scenario: an Islamic financial institution is interested in a specific project but it has not yet conducted the necessary studies about it and it did not want to lose the opportunity. In this case, it could enter a contract on the condition that whenever it returned the money that it had received, there will be no deal.³⁸

³⁷ Abd al-Sattar Abū Ghuddah, "Khiyār al-Naqad wa Taṭbiqātuḥu fi Mu'āmalāt al-Mašārif al-Islāmiyyah" *Amāl al-Nadwah al-Fiqhiyyah al-Thāniyah*, Bayt al-Tamwīl al-Kuwaitī, Kuwait, 1993, pp. 186–188; Muhammad Shibbir, "Khiyār al-Naqd wa Taṭbiqātuḥu fi Mu'āmalāt al-Mašārif al-Islāmiyyah" *Amāl al-Nadwah al-Fiqhiyyah al-Thāniyah*, Bayt al-Tamwīl al-Kuwaitī, Kuwait, 1993, pp. 222–225.

³⁸ See Khālid 'Abd Allāh Shu'aib, "Khiyār al-Naqad wa Taṭbiqātuḥu fi Mu'āmalāt al-Mašārif al-Islāmiyyah" *Amāl al-Nadwah al-Fiqhiyyah al-Thāniyah*, Bayt al-Tamwīl al-Kuwaitī, Kuwait, 1993, p. 244.

However, it should be noted in this case that if the beneficiary of *khiyār al-naqd* is just taking the amount or the price in order to benefit from it and then returning it to the buyer and recollecting his commodity in a tricky manner (*ḥilah*), it will be a real case of *qarḍan Jarra naf'an* and therefore, the possibility is great of a *ribā* transaction.

CHAPTER TEN

‘ARBŪN RISK MANAGEMENT AND OPTIONS

‘*Arbūn* refers to a sale in which the buyer deposits earnest money with the seller as part payment of the price in advance, but agrees that if he fails to ratify the contract, he will forfeit the deposit money, which the seller can keep”.¹ It is also defined as “a transaction whereby the buyer pays only a small part of the price of a commodity (for instance two *dirhams*), on the understanding that the seller will retain this amount if the sale is not finally concluded due to withdrawal of the buyer”.²

However, Imām Mālik gives a somewhat more general definition of ‘*arbūn*. It holds when a person buys or rents an animal and says to the seller or the owner of the animal, “I will give you one *dīnār* or one *dirham* or more or less and if I ratify the sale or the rent contract, the amount I gave will be part of the total price. And if I cancel the deal, then what I gave will be for you without any exchange”.³ The above definition of Imam Mālik shows that ‘*arbūn* is not only possible in a sale contract but also in a rent or leasing contract. This will widen the use of ‘*arbūn* as we will see later. However, there is disagreement among the classical schools of Islamic law about the legality of ‘*arbūn*.

The Majority⁴ held that it is an invalid contract and considered it to be akin to misappropriating the property of others. Moreover, it involves an unknown option or condition, which amounts to *gharar*. The Ḥanbalī school, on the other hand, considers it as a legal contract. ‘Umar, the second caliph, and his son ‘Abd Allāh Ibn ‘Umar held a similar position. Among the followers certain prominent figures including Mujāhid, Sa‘īd Ibn al-Musayyib, Ibn Sīrīn, Nāfi‘ Ibn al-Ḥārith, and Zaid

¹ Kamali, *Islamic Commercial Law an Analysis of Options and Futures*, p. 365.

² Mohammad Ali El-Gārī, “Toward An Islamic Stock Market”, *Islamic Economic Studies*, vol. 1 no. 1 December 1993, p. 14.

³ Al-Bājī *al-Muntaqā Sharḥ al-Muwata’*, vol. 4, p. 158.

⁴ See for instance, Ibn Rushd, *Bidāyat al Mujtahid*, vol. 2, p. 161. Al-Dirdīr, *al-Sharḥ al-Kabīr*, vol. 3, p. 63; Al-Nawawī, *Mugnī al-Muhtāj*, vol. 2, p. 39; Ibn Qudāmā, *al-Mughnī*, vol. 4, p. 224.

Ibn 'Aslam also held it to be lawful.⁵ The source of this difference lies in the authenticity of two *aḥādīth* reported on the issue, which seem to contradict each other.

Thus, the majority relied on a *ḥadīth* reported by Imām Mālik in al-Muwaṭṭa' as well as by Imām Aḥmad, Nasā'ī, Abū Dawūd and Ibn Mājāh to the effect that the Prophet (PBUH) prohibited the sale of 'arbūn. However, the *ḥadīth* is considered to be weak (*munqaṭi'*).⁶

On the other hand, the Ḥanbalī School relied on a *ḥadīth* reported by 'Abd al-Razzāk to the effect that the Prophet was asked about 'arbūn sale and he declared it permissible. But this *ḥadīth* is also declared to be weak (*mursāl*).⁷ In addition, the Ḥanbalīs relied on the report of Nāfi's Ibn al-Ḥārith, the officer of the caliph 'Umar in Makkah to the effect that he bought from Safwān Ibn Umayyah a prison house for the caliph 'Umar for four thousand *dirham* on condition that if the caliph approved of it, the deal would be final, otherwise Safwān would be given four hundred *dirhams*.⁸

Further evidence could be invoked in support of the legality of *bay' al-'arbūn* such as the *ḥadīth*: "Muslims are bound by their stipulations unless it be a stipulation which declares unlawful what is permissible or permits what is unlawful".⁹

Also it is reported in al-Bukhārī and narrated by Ibn Sirīn that "a man said to a hirer of animals, 'prepare your travelling animals and if I do not go with you on such and such a day, I shall pay you a hundred *dirhams*'. But he did not go on that day. Shuraiḥ said: If anyone puts a condition on himself of his own free will without being under duress, he has to abide by it. Also it is narrated by Ayyūb from Ibn Sirīn that "A man sold food, and the buyer told the seller that if he did not come to him on Wednesday, his deal would be cancelled, and he did not turn up on that day". Shuraiḥ said to the buyer "You have broken your promise" and gave the verdict against him. Ibn Ḥajar said, Sayid Ibn Manṣūr has completed this transmission by the chain of Sufyān from

⁵ See, for instance, Ibn Qudāmā, *al-Mughnī*, vol. 4, p. 234; al-Qurtubi, *Ahkām al-Qur'ān*, vol. 5, p. 150 and Ibn Qayyim, *Ilām al-Muwaqqi'in 'an Rab al-'Ālamīn*, vol. 3, p. 389.

⁶ See, for instance Ibn Ḥajar, *Talkhīs al-Ḥabīr*, vol. 3, p. 17; al-San'āni, *Subul al-Salām*, vol. 3, p. 17 and al-Shawkāni, *Nayl al-Awtār*, vol. 5, p. 153.

⁷ See al-Shawkāni, *Nayl al-Awtār*, vol. 5, p. 153.

⁸ Ibn Qayyim, *Ilām al-Muwaqqi'in 'an Rab al-'Ālamīn*, vol. 3, p. 389.

⁹ Al-Bukhārī, *Saḥīḥ al-Bukhārī with Faṭḥ al-Bārī*, Book of conditions (Shurūṭ), v. 5, p. 354.

Ayyūb. The conclusion from this *ḥadīth* is that Shuriaḥ in both cases had given the verdict against the person who makes the condition against himself without duress.¹⁰

A number of contemporary Muslim jurists have opted for the admission of 'arbūn. Thus, al-Qaraḍāwī, in his analysis and comparison of the evidence for and against the sale of 'arbūn, stated that the opponents of 'arbūn have relied on a *ḥadīth* and the argument that it is premised on a condition, which entails appropriation by the seller of the buyer's property without any exchange. As for the *ḥadīth*, it is unreliable. But since the *ḥadīth* upon which the proponents of *bay' al-'arbūn* rely is also weak, al-Qaraḍāwī observes that the issue should consequently be determined on rational grounds and here we note that Imam Ahmad relied on the precedent of Umar Ibn al-Khaṭṭab and has considered 'arbūn to fall into the category of lawful appropriation. This ruling, al-Qaraḍāwī adds, is more suitable to our own time and is in greater harmony with the spirit of the *sharī'ah*, which seeks to remove hardship and facilitate convenience for the people.¹¹

Meanwhile, al-Zuhaili rejected al-Shawkānī's argument that since the two *ḥadīths* contradict each other in that one prohibits 'arbūn while the other legalizes it, we should opt for the prohibition because, as it is well known in Islamic jurisprudence, if there are two conflicting commands on prohibition and permissibility, the prohibition should be given priority.¹² Al-Zuhailī said the evidence of the two parties, in this case, is not equal. The proponents relied on the precedent of 'Umar Ibn al-Khaṭṭab which could be considered as an *ijmā'*, because he was not opposed by any of the companions.

Muṣṭafā al-Zarqā highlighted the utility of 'arbūn in modern commerce and the support it has received in general custom and legislation. 'Arbūn provides a useful formula, which can be utilized to facilitate a credible commitment, or a surety that the buyer will not change his mind after finalising a sale. However, if he does so the seller can be compensated for possible loss that has been caused as a result. The need for such assurance is more evident in modern times when large orders have to be entertained by making elaborate preparations involving a chain of other subsidiary transactions that incur additional expenditure.

¹⁰ Ibid.

¹¹ Al-Qaraḍāwī, *Sharī'at al-Islām*, p. 114.

¹² al-Shawkānī, *Nayl al-Awṭār*, vol. 5, p. 153.

It is likely that the seller who holds his goods or manufactures them for the purpose, and waits until the buyer ratifies the sale may lose the opportunity of selling his goods or may fail to sell them for a good price, in which case he should be entitled to compensation, and *'arbūn* responds to this need.¹³

‘Abd Allāh Ibn Manī’, in his rejection of the opponents’ argument that there is *gharar* in *'arbūn*¹⁴ since in such a contract there is no time limit for the exercise of the right of cancellation of the contract said, “We agree that there should be a time limit for the exercise of this right, otherwise the possibility of *gharar* may have some grounds”.¹⁵ Yet, it should be noted that some sources of the Ḥanbalī School did not mention a time frame for the exercise of this right. But ‘Abd Allāh al-Bassām argues that the Ḥanbalīs, as a matter of principle, reject all conditions of unlimited time in a contract, therefore, even if sometimes, some Ḥanbalī scholars did not mention explicitly this limitation in their works, they are considering it. Moreover, some other Ḥanbalī’s scholars such as al-Maqḍīsī¹⁶ have mentioned it. Besides, it could be argued that the issue of time limitation in this case is similar to that of *khiyār al-shart*.¹⁷ Some other contemporary scholars, such as Mājid Abū Ruqayyah¹⁸ and Lāshīn Mohammad al-Qayyātī¹⁹ have also opted for the legality of *'arbūn*.

Considering the fact that some contemporary scholars have opposed *bay' al-'arbūn* on this ground, namely there is *gharar* in *'arbūn* since in such a contract there is no time limit for the exercise of the right of cancellation of the contract, the participants in the Islamic Fiqh Academy discussion on *'arbūn* opted for the inclusion of this condition in

¹³ Quoted by Kamālī, *Islamic Commercial Law an Analysis of Options and Futures*, pp. 367–8.

¹⁴ For more elaboration on the existence of *gharar* in *bay' al-'arbūn* see, Šiddīq al-Ḍarīr, “Bay' al-'Arbūn”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 8, vol. 1, 1994, pp. 647–669.

¹⁵ ‘Abd Allāh Ibn Manī’, “Baḥṭh fī Ḥukm Bay' al-'Arbūn”, *Majallat al-Buḥūth al-Islāmiyyah*, Riyadh Saudi Arabia, p. 170.

¹⁶ Al-Maqḍīsī, *Ghāyāt al-Muntahā*, al-Maktab al-Islāmī, Damascus, 1961, vol. 2, p. 26.

¹⁷ ‘Abd Allāh al-Bassām, *Majallat Majma' al-Fiqh al-Islāmī* (discussion about *bay' al-'arbūn*) no. 8, vol. 1, 1994, p. 766.

¹⁸ Mājid Abū Ruqayyah “Ḥukm bay' al-'arbūn, fī al-Islām”, *Buḥūth Fiqhiyyah fī Qaḍāyā Iqtisādiyyah Mu'āširah*, pp. 393–415.

¹⁹ Lāshīn Mohammad al-Qayyātī, “Bay' al-'arbūn”, *Majallat al-sharī'ah wa al-Dirāṣāt al-Islāmiyyah*, no. 26, 1995, pp. 111–154.

every ‘*arbūn* contract in order to solve the problem.²⁰ It is worth noting that the opponents of ‘*arbūn* have objected to it also on other grounds. Al-Ḍarīr, for instance, opposed ‘*arbūn* also on the grounds that it has connotations of a conventional option and it may be used for speculative purposes.²¹

On the other hand, it should be noted that the legislation of several Arab countries has opted for the legality of ‘*arbūn* as an indication that both parties in the contract have the right to cancel the contract during the agreed period except for the civil law of Iraq, which considers ‘*arbūn* as an indication that the contract is final and conclusive. Thus, Article 103 of the Egyptian civil code, Article 74 of the Kuwaiti civil code, article 103 of the Jordanian civil code And 104 of the Syrian civil code state that ‘*arbūn* is an indication that both parties have the right to cancel the contract during the agreed period.²²

The Legal Status of Bay‘ Al-‘Arbūn

It may be asked whether ‘*arbūn* is a kind of clause for liquidated damages or a kind of penalty, which will be imposed upon the one who fails to honor his obligation as a compensation of imminent harm, or is it something else? If we consider ‘*arbūn* as a kind of clause for liquidated damages, this would mean that the damage should be assessed by a court of law even if the parties have agreed at the beginning to a certain amount of compensation. If what is agreed upon between the parties is more than the real damage, the court would reduce it to the appropriate amount of the real damage and if it is less, then, the one who fails to honor his obligation should be obliged by the court to pay more. This is totally different from the nature of ‘*arbūn*, which is an exchange of the “right” to cancel the contract as it is agreed upon

²⁰ ‘Abd al-Razzāq al-Sanhūrī, *Masādir al-Ḥaqq*, vol. 2, p. 101. al-Zuhailī, “Bay‘ al-‘Arbūn”, *Majallat Majma‘ al-Fiqh al-Islāmī*, no. 8, vol. 1, 1994, p. 698. Rafiq al-Miṣrī, “Bay‘ al-‘Arbūn”, *Majallat Majma‘ al-Fiqh al-Islāmī*, no. 8, vol. 1, 1994, p. 729; al-Qaradāwī, *Majallat Majma‘ al-Fiqh al-Islāmī* (discussion about bay‘ al-‘arbūn) no. 8, vol. 1, 1994, p. 769.

²¹ *Majallat Majma‘ al-Fiqh al-Islāmī* (discussion about-‘arbūn), p. 756.

²² See, ‘Abd al-Majīd al-Ḥakīm, *al-Kāfi fi Sharḥ al-Qānūn al-Madanī al-Urdinī wa al-Qānūn al-Madanī Irāqī wa al-Qānūn al-Madanī al-Yamanī fi al-Iltizāmāt al-Shakḥsiyyah*, pp. 264–274; *al-Waṣīt Sharḥ al-Qānūn al-Madanī al-Urdinī*, al-Ḍār al-‘Arabīyah li al Mawsū‘āt, vol. 2, pp. 134–141.

between the parties, and cannot be subjected to the court's intervention. Moreover, in the case of liquidated damages, the occurrence of the damage is a condition for receiving the compensation. If no damage has happened, then, there are no grounds for compensation and this is not the case with *'arbūn* where the beneficiary is entitled to it whether there is damage or not.

Similarly, if we consider *'arbūn* as a penalty to compensate against the harm suffered by the owner of the commodity because he has reserved his commodity for the buyer and waited for him to ratify the contract or he may have lost the opportunity of selling his item at a good price, a court intervention is necessary to assess the damage. However, this is not in line with the spirit of *'arbūn* where the parties have agreed and fixed the amount just for the "right" to cancel the contract.²³ Therefore, it could be concluded that what is paid as *'arbūn* is in exchange for the right to cancel the contract and not compensation for the damage.

'Arbūn in Currency Exchange or ṣarf

As explained before, one of the requirements of legal currency exchange is that the taking of possession should be on the spot and hand to hand. Based on this principle it could be deduced that it is not possible to use *'arbūn* in currency exchange. This is because *'arbūn* means the deferment of taking possession, which will result consequently in *ribā al-nasī'a*. Thus, it seems that there is a general agreement among contemporary Muslim jurists that *'arbūn* is illegal in currency exchange.²⁴

'Arbūn in Commodities and Services

It is clear from Imam Malik's definition of *'arbūn* mentioned above that it is practicable in *bay'* and *ijārah*. Therefore, it could be said that

²³ See for instance, 'Abd al-Razzāq al-Sanhūrī, *Maṣādir al-Ḥaq*, pp. 89–103; al-Sanhūrī, *al-Wasīt*, vol. 4, p. 90; 'Abd Allāh Ibn Manī', "Baḥth fi Ḥukm Bay' al-'Arbūn", pp. 173–175; Rafīq al-Maṣrī, "Bay' al-'Arbūn", pp. 726–729.

²⁴ See for instance, al-Zhailī, "Bay' al-'Arbūn", *Majallat Majma' al-Fiqh al-Islāmī*, no. 8, vol. 1, 1994, p. 699; Rafīq al-Maṣrī, "Bay' al-'Arbūn", *Majallat Majma' al-Fiqh al-Islāmī*, no. 8, vol. 1, 1994, p. 731; Ṣiddīq al-Ḍarīr, "Bay' al-'Arbūn", *Majallat Majma' al-Fiqh al-Islāmī*, 1994, no. 8, vol. 1, p. 705; Abd 'Allāh Ibn Manī', "Baḥth fi Ḥukm Bay' al-'Arbūn", *Majallat al-Buhūth al-Islāmīyyah*, Riyadh, Saudi Arabia, pp. 177–178.

'*arbūn* is legal with regard to commodities and services. Sale in Imām Mālik's definition is an example of the sale of commodities while *ijārah* is an example of services.²⁵

To give an example of '*arbūn* in commodities, we may choose the example given at the beginning of our discussion on options regarding the purchase of a car. Although the above example has been given as a kind of option it could also be an example of '*arbūn*, especially in its early stage because the two cases are the same except for one minor difference. Thus, as it is explained above you have decided that you want to buy a new car. You select the type of the car you want and go to your local dealer. At the dealer's showroom, you decide on the exact specifications of your car's colour, engine, size, wheel trim etc. The car is on offer at £20,000, but you must buy the car today. You do not have that amount of cash available and it will take a week to organize a loan. You offer the dealer £100 if he will just keep the car for a week as '*arbūn* (which is in the above example an option). At the end of the week, if you buy the car, the £100 will be part of the price while if you do not turn up, the £100 will be for the seller (however, in the above example the £100 is his whether or not you buy the car). This is the only difference between the two cases. Thus, you have entered into an '*arbūn* in the present example while it is a call option contract in the earlier example.

If, during the week, you discover a second dealer offering an identical model for £19,500, you will not take up your option with the first dealer. The total cost of buying the car is £19,500+ £100 = £19,600, which is cheaper than the first price you were offered. However, if you find that the first dealer's price is lower than the second dealer's, for instance, and buy the car from the first dealer, the car will cost a total of £20,100. If you decide not to buy the car at all, you will lose your £100 to the car dealer. Thus, you are hedging against a price rise in the car.

To give an example of '*arbūn* in *ijārah*, the following example may be considered. Suppose the ḥaj season is approaching and the different ḥaj management agencies are looking for the best means of transportation for their clients which is at the same time beneficial for their business activities. Suppose, Malaysian Airline is the first airline company to offer a special airfare for the occasion and suppose it is RM 2500 per ticket.

²⁵ Also see, 'Abd Allāh Ibn Manī, "Baḥṭh fī Ḥukm Bay' al-'Arbūn", pp. 178-9; al-Zuhailī, "Bay' al-'Arbūn", 700; Rafīq al-Miṣrī, "Bay' al-'Arbūn", p. 732.

Immediately, Tabung Ḥaji as a ḥaj management company approaches Malaysian Airlines so as to conclude a deal for the transportation of its 10,000 pilgrims this year. Given the fact that Malaysian Airlines' offer is limited, other ḥaj agencies may also compete to get it. And at the same time, Tabung Ḥaji is hoping that other airline companies may also offer such a special airfare, considering the fact that, some airline companies, at normal times, have cheaper fares than Malaysian Airlines. However, a special airfare from these companies is just a possibility. Therefore, Tabung Ḥaji decides to enter into an *ijārah* with 'arbūn with Malaysian Airlines for the transportation of its customers to the Holy Land. Thus, Tabung Ḥaji pays as 'arbūn RM 200 for every air ticket. The 'arbūn time period is 45 days. Twenty days after the signing of this contract, another airline company offers a much better deal. Suppose that it is just RM 2000 per ticket. Tabung Ḥaji seizes the opportunity and concludes a deal with the new company while losing its 'arbūn given to Malaysian Airlines. Thus, rather paying RM 2500 per ticket Tabung Ḥaji is now paying just RM 2000 + the RM 200, which it has forfeited to Malaysian Airlines. However, if the contrary situation happens and no other airline has offered a cheaper airfare, but rather higher than that of Malaysia Airlines, then, Tabung Ḥaji will finalise its contract with Malaysian Airline on the previous terms of the contract. Thus, Tabung Ḥaji has been able to manage its risk of getting the best service for the transportation of its customers to the Holy Land.

'Arbūn in Shares Trading

Considering the fact that shares trading is accepted as legal by almost all contemporary Muslim jurists and bearing in mind that 'arbūn is legal in any sale which could be deferred in Islamic law, therefore, 'arbūn in share trading is legal.²⁶ Needless to mention that this rule is limited to shares of companies dealing in permissible or *ḥalāl* products and which are not involved in *ribā* or gambling.

To illustrate the above situation, suppose an investor has completed a study to invest in a specific project but the work in the new project will not start until the coming month. Therefore, he decides to invest in the

²⁶ See al-Zuhaili, "Bay' al-'Arbūn", p. 700; Rafiq al-Miṣrī, "Bay' al-'Arbūn", p. 733; 'Abd Allāh Ibn Manī', "Baḥṭh fi Ḥukm Bay' al-'Arbūn", pp. 179–180.

stock market by buying shares from a very sound company in the hope that the share prices of the company will go up in the coming days, then he will be able to sell these shares in the spot market in order to gain some profit before starting to finance his initial project. However, due to the volatile nature of shares trading, there is a possibility that the prices may go down as well. Therefore, he decides to buy the shares through ‘*arbūn*. Thus, if his expectations are fulfilled, he will sell the shares and make some profit. However, if his expectations are proven to be wrong, his loss will be limited to only the amount paid as ‘*arbūn* while the financing of his original project will not be affected.

‘*Arbūn in Murābahah*

Murābahah is generally defined as selling a commodity with cost plus a margin. *Murābahah* in this sense is an ordinary kind of sale and therefore, ‘*arbūn* is legal. However, if we mean by *murābahah* what is practiced by Islamic banks nowadays or *al-murābahah lil’āmir bi al-shirā’*, the arrangement between the bank and the customer is just a promise and not a real contract while the agreement between the bank and the real owner of the commodity is a contract. Such a deal involves a promise to buy/sell, which implies deferment. Hence, it cannot coexist with ‘*arbūn*. Therefore, ‘*arbūn* in such *murābahah* will be illegal if we consider the promise as not binding.²⁷

However, if the promise between the bank and the customer is considered as binding as it is the prevailing practice of Islamic financial institutions backed by the decision of the Islamic Fiqh Academy, the possibility of ‘*arbūn* in *murābahah lil’āmir bi al-shirā’* may be considered.

Addressing the issue, Ibn Manī’ said:

Considering the fact that ‘*arbūn* is possible only in a contract as a part of the whole price, then there are no grounds to legalize ‘*arbūn* in *murābahah lil’āmir bi al-shirā’* because the agreement between the bank and the customer is just a promise. However, this does not mean it is illegal for the promisor to give the promisee a certain amount of money in exchange for the fulfillment of his promise. However, this could not be considered as ‘*arbūn* but it could be a stipulation of liquidated damages and it is up to the parties’ agreement. In other words it is up to what the parties agreed

²⁷ al-Zuhaili, “Bay’ al-‘Arbūn”, p. 701; ‘Abd Allāh Ibn Manī’, “Baḥṭh fi Ḥukm Bay’ al-‘Arbūn”, p. 180; Rafīq al-Maṣrī, “Bay’ al-‘Arbūn”, pp. 734–5.

upon whether to consider it as a part of the whole price or not because Muslims are bound by their stipulations.²⁸

A close attention at this statement reveals that despite Ibn Manī's refusal to call it *'arbūn*, it seems that there is no genuine difference between the two. Going one step further, Tariqullah Khān suggested an example of an *'arbūn in murābahah lil'āmīr bi al-shirā'* the legality of which somehow needs to be legally evaluated considering the fact that this kind of *murābahah* constitutes about 75% of all transactions of Islamic banks.

To clarify his suggestion, Tariqullah Khān said, "Accordingly the client who orders goods from the Islamic bank is required to pay some part of the price in advance as a commitment price. As in *'arbūn in murābahah*, for any reason of his own, the client may abandon the transaction by refusing to buy the goods and forgoing the commitment price. Hence, for all practical purposes, in a *murābahah* transaction, the client buys a call option on the goods of the bank. Suppose, the client buys these goods for resale purposes, as is the case with the common stocks, would the client be able to sell the ordered goods before he actually takes possession of them?²⁹

To give an example of the above case, Tariqullah Khān cites a Muslim country which has ordered the Islamic bank for the supply of gasoline on the basis of *murābahah* (has bought a call option on the gasoline transaction of the Islamic bank) with the payment of US\$100,000 as a commitment price. Suppose the shipment of the gasoline to the country has been initiated and the ship is on the high seas, but is still far from the physical possession of the country. Suppose market conditions undergo changes from the time of placing the order to the time of the present location of the tanker. Therefore, the tanker-owner is motivated to offer US\$200,000 to the Muslim country and to buy the gasoline and redirect it to another location. Assuming that the bank has no objection to this arrangement in which the tanker owner replaces the Muslim country in the contract, the point here to answer, Tariqullah Khān questioned: can the Muslim country earn the additional US\$100,000 over and above the commitment price, which it has already paid? Suppose, two things happen simultaneously: the Muslim country is no longer interested in the gasoline for some reasons of its own and at the same time it has

²⁸ Ibn Manī, "Baḥṭh fi Ḥukm Bay' al-'*Arbūn*", pp. 180–181.

²⁹ See, Tariqullah Khan, "Derivatives: Discussion Forum", Islamic finance. net. Journal, p. 4.

also this offer from the tanker owner. What type of decision will maximise the social as well as financial value and benefit in this situation? Moreover, *murābahah* could very well be a leverage device.³⁰

However, it seems that in the above situation the Muslim country has sold its right to *'arbūn* or its right to option and it is not just a simple *murābahah lil'āmir bi al-shirā'* case. It goes beyond that and the legality of such a transaction could only be justified if we accept the sale of pure right, an issue that will be elaborated later.

Moreover, the proposed case stated above could be better handled through *salam* rather than *murābahah*. First of all, in principle the agreement between the bank and the customer under *murābahah* is just a promise, but it has been considered as binding by modern jurists by way of necessity due to the complexity of modern commercial transactions and because of that these scholars always call for the use of other instruments of investment rather than *murābahah*. Moreover, no scholar has considered the binding promise in *murābahah* as a full type of contract while *'arbūn* in principle is applicable only with a contract. In contrast, such scepticism would not arise with *salam* because it is a genuine contract, then the problems associated with the binding status of the promise will be overcome.

Secondly, there is a difference of opinion among Muslim jurists about the legality of selling something before it is in the possession of the buyer as in the above case. Such a difference of opinion will be much wider if the arrangement is just a promise and not a contract whether it is binding or not as is the case with *murābahah lil'āmir bi al-shirā'*. The issue of sale before possession in *salam*, although disputed by the majority, is meanwhile, legalized by the Mālikī school and very well defended by Ibn Taymiyyah and his disciple Ibn Qayyim. Therefore, to resort to a solution, which has a precedent, and which has a strong legal basis is much preferable to a case with disputed legal grounds and without precedent in the work of the early scholars. Lastly, the issue of selling an item before taking possession of it could be solved through the idea of parallel *salam*, which is not possible in *murābahah*.

On the other hand, it should be noted that the expression *'arbūn* in *murābahah* has been used in several works on Islamic finance. It seems that what these scholars mean by *'arbūn* is a penalty or liquidated damages on the one hand, and a pledge or *rahan* on the other, rather

³⁰ Ibid.

than *‘arbūn* in its strict legal sense. Thus several Islamic institutions are including in their contracts on *murābaḥah lil’āmir bi al-shirā’* a liquidated damages clause but under the name of *‘arbūn*. For instance, in the resolution adopted by the Second Conference on Islamic banks held in Kuwait, it is stated that *‘arbūn* in *murābaḥah* is legal on the condition that the Islamic bank should not take from the amount of *‘arbūn* given to the client more than the real damage.³¹ Meanwhile, a practical approach to the above is reflected in Dubai Islamic bank’s sample of contract on *murābaḥah* and the general steps for *murābaḥah* sale as adopted by the bank.³²

Furthermore, the following question addressed to the Sharī‘ah Board of the Faisal Islamic bank of Bahrain may shed more light on the issue. The bank accepts advance payments as *‘arbūn* from its clients when it receives their order to purchase. The advance is then deposited in an account maintained specifically for such payments until the time the goods (that were ordered by the bank on behalf of its client) arrive and the client takes possession of them. This amount is kept as a guarantee against payment of the agreed amount of instalment in the *murābaḥah* contract. There are certain clients, however, who seek the return of an appropriate amount of the advance to their current account with every payment of the instalment. What is your opinion on this matter?

The Sharī‘ah Board answered that *‘arbūn* may be defined as what is paid as a first part of the whole price when a contract is concluded, and the buyer’s option either retain the good or nullify the contract. In the event the contract is nullified, the *‘arbūn* advance will belong to the seller. If the contract is not concluded, however, and never passes beyond being a pledge (on the client’s part to buy from the bank when the goods arrive), then, whatever the client (who desires to purchase) pays in advance would not be considered *‘arbūn*. Under such circumstances, the amount will remain as a trust in the hands of the seller until the time the contract of *murābaḥah* is actually concluded; and thus time it will become a part of the overall price. In case the two parties consider the amount paid, (once the contract has been concluded), a pledge or *rahan* that may be held against the instalments owned by the buyer, then, this will be lawful as long as the parties abide by the rules

³¹ See, Bank Dubai al-Islāmī, *Fatāwā Shar‘iyyah fi al-‘Amāl al-Maṣrifīyyah*, 1996, vol. 1, p. 33.

³² See, Bank Dubai al-Islāmī, *al-Murābaḥah*, Markaz al-Tadrib wa al-Buḥūth, 1996, pp. 14–17 & 26–29.

of the *sharī'ah* that a cash pledge must not be used to the advantage of the one holding it, i.e. the pledgee. Therefore, if the amount is invested, the profits earned on the investment will accrue to the benefit of the pledger (not the one holding it); and such an act should not take place unless the pledger or the bank's client gives his or her permission to the pledgee to make such an investment.³³

In another similar *fatwā*, the *Sharī'ah* Board confirmed the first *fatwā* that in the case of such an advance payment before the conclusion of the contract, or the case of a pledge to purchase, such as that in *murābaḥah li'l-āmir bi al-shirā'*, the advance given by the purchaser, is not called '*arbūn*, nor does it have the same legal status. Instead it is an amount given to the "purchaser", in case he fails to live up to the end of his bargain, the advance amount may serve to compensate the bank for its expenses. If there is a remainder, after the bank is compensated, it will be returned to the client. If the advance is insufficient to compensate, the "purchaser" should pay the rest. This is the opinion of those who hold the view that a pledge or a promise to purchase in *murābaḥah li'l-āmir bi al-shirā'* is binding.³⁴

It may be noted here that despite the fact that the above clause is not an '*arbūn* as it is legally defined but rather looks like a clause on liquidated damages or a penalty, the Islamic financial institution using it could manage its risk exposure to some extent. Although the above clause is apparently similar to a clause of liquidated damages, in practice some Islamic banks try to avoid the transfer of the dispute over the assessment of the real damage, inflicted on it following the customer's failure to fulfill his binding promise to purchase, to the court as it is the norm in dealing with such cases. They will try to insert, from the beginning, a clause in the contract that in such cases, (namely the assessment of the real damage inflicted), the dispute should be referred to the *Sharī'ah* Board of the Islamic bank for a final decision which shall not be contested in court.³⁵ Indeed, such a clause will render the issue, somehow, different from a pure penalty and save the Islamic bank the cost and time of court proceedings. On the other hand, it should be

³³ See Yusuf Talal DeLoenzo (editor and translator) *A Compendium of Legal Opinions on the Operations of Islamic Banks*, Institute of Islamic Bank and Insurance, UK, 1998, p. 50.

³⁴ See, *ibid.*, pp. 21–22.

³⁵ See Dubai Islamic bank's sample on *murābaḥah al-Murabaḥah*, Markaz al-Tadrib wa al-Buḥūth, Bank Dubai al-Islāmī, 1996, p. 29.

noted that the Islamic Fiqh Academy in its final resolution no. 76/3/d8 disallows '*arbūn* in *murābahah lil'āmir bi al-shirā'*'.

'*Arbūn* in Salam

Salam is defined as the sale or purchase of a deferred commodity for a present price.³⁶ Thus, in a *salam* contract, generally the price is paid in advance while the commodity is deferred to an agreed date in the future, such as, buying two tons of wheat which will be delivered one year later while the price is paid on the spot. In such a case if the buyer wants to cancel the contract before its maturity while he has already paid the price of the commodity he intended to buy, he could ask for the cancellation of the contract through *iqālah*. If the seller accepts his request, the contract will be cancelled. Even if he asks for compensation for this cancellation no legal problem would arise. However, a question will arise whether it is legal for the parties to insert a condition in the contract from the beginning that, in such a situation, the buyer shall give the seller a specific amount of money as an '*arbūn*. It seems that there is no legal problem in such a deal and the buyer should pay the '*arbūn* to the seller if the initial agreement stipulates so, and there is no possibility of *ribā* in this transaction. It is the buyer who has already paid the price and will forfeit part of his money in exchange for the right to cancel the contract. However, if the seller wants to cancel the contract, the possibility of *ribā* arises. This is because he has already received the price, which is for instance, US\$1,000. Then, he will return it plus US\$100 as '*arbūn* or to get the right to cancel the contract after three months from the conclusion of the contract, the possibility of *ribā* is clear and it is similar to the case of borrowing US\$1000 and returning it US\$1,100 after three months.

It has been reported from some prominent scholars from the Tabi'īn such as Said Ibn al-Musayyib, Shuraih, Ibn Sīrīn, Ibrāhīm al-Nakha'i, Said Ibn Jubair, Ṭāwūs and Ibn 'Umar from the companions, that it is legal for the buyer who would like to return the commodity and cancel the contract after the taking of possession, and the seller asks for some money in exchange for such a cancellation to do so. Therefore, the above case could be accommodated by an analogy to this case based on the

³⁶ Ibn 'Ābidin, *Hāshiyat Rad al-Muhtār*, p. 206.

opinion of the above scholars. This form of *iqālah* has some similarity with *bay' al-'arbūn*. In fact, Imam Ahmad used the case as evidence for the legality of *'arbūn*. In both cases, there is a cancellation of the contract in exchange for a specific amount of money. On the other hand, some others such as Ibn 'Abbās, al-Sh'abī Atā' and Ḥammād maintained that it is illegal.³⁷ They described this form of *iqālah* as a kind of a new contract, and in consequence it is illegal on the ground that it involves the combination of two contracts (the contract of selling the commodity and that of cancelling it at a discounted price) in a single transaction.³⁸

However, it seems that this is not a form of combination of two contracts as it has been explained before. It is just a kind of stipulation in the contract, which does contradict its objectives and, therefore, Muslims are bound by their stipulations unless it is a stipulation which prohibits what is allowed, and vice versa. Therefore, it could be said that *'arbūn* in *salam* is permissible if it is stipulated by the buyer. However, if it is stipulated by the seller it will be illegal.

'Arbūn in 'Istiṣnā'

Similar to the case of *salam* as described above, where the purchaser could ask for *'arbūn* without contravening the principles of the *shari'ah*, the buyer can also opt for *'arbūn 'istiṣnā'*. Yet, some have voiced reservations that such a deal would be a kind of *talfiq* because *'istiṣnā'* is only recognized by the Ḥanafī school as a non-binding contract while *'arbūn* is only legalized by the Ḥanbalī school. Thus, to add an option to the Ḥanafī opinion for which *'istiṣnā'* is not binding seems a radical step.³⁹

However, such an argument will be acceptable only if we consider *talfiq* as a genuine source in Islamic jurisprudence. In reality *talfiq* is not at all a source of Islamic law. It is a kind of *taqlid* and since *taqlid* is not a part of the *shari'ah*, *talfiq* will also be seen as such. Yet, some modern scholars have argued in its favor but this will not change the reality. Secondly, the imitation or the *taqlid* of the prevailing schools

³⁷ See *Muṣannaf Ibn Abī Shaybah*, vol. 6, p. 108; *Muṣannaf 'Abd al Razzāq*, vol. 8, p. 18.

³⁸ Ibn Rushd, *al-Muqaddimāt*, p. 548.

³⁹ See, Vogel and Hayes, *Islamic law and Finance*, p. 282.

is just a kind of weakness and lack of *ijthād* although even some early scholars have mistakenly argued for such an act. Therefore, to judge the legality of *'arbūn* in *'istiṣnā'*, the only requirement which needs to be considered is whether or not such a transaction is in line with the general principle of freedom of contracts and conditions. Thirdly, the Islamic Fiqh Academy, in its resolution no. 66/3/7, has already endorsed the opinion that *'istiṣnā'* should be binding on both parties and could include a clause of liquidated damages. Similarly, it has endorsed that *'arbūn* is legal in all kinds of sales except those kinds of sale which require immediate delivery and *'istiṣnā'* is not such a contract. Therefore, it could be concluded that *arbūn* in *'istiṣnā'* is legal.

Keeping in mind the above situation, suppose Kuwait Airways wants to purchase ten Boeing 777 aircraft to be delivered in two years. Boeing requires progress payments roughly parallel to the growing value of the partially completed planes and an *'istiṣnā'* contract is drawn up. However, Kuwait Airways is uncertain about the level of future demand and wants the right to cancel the order at any time within the first year of the agreement. The purchaser (with or without a parallel *'istiṣnā'* arrangement providing financing) contracts an *'arbūn* with a non-refundable deposit that will properly compensate Boeing (and any financing intermediary) for losses and inconvenience if the cancellation option is exercised.⁴⁰

'Arbūn as the Islamic Alternative to Options

Our purpose here is not to find a way to accommodate conventional options as they are used nowadays in the international market but to formulate a type of contract that fulfills the objectives of options as a means of risk management and the possibility of transferring it from one investor to another. *'Arbūn*, as discussed above, has some similarities with options. Thus, the basic rationale of options resembles that of *'arbūn* especially in the sense that both can be used as risk reduction strategies, or a method by which traders might wish to give themselves flexibility before committing themselves to large contracts.

⁴⁰ Ibid., pp. 281–282.

‘Arbūn as an Alternative to Call Option

Addressing the relationship between *‘arbūn* and a call option, Kamālī maintains that the basic rationale of an option resembles that of *‘arbūn* especially in the sense that both can be used as risk reduction strategies. Suppose that a bakery owner wishes to expand his business and thinks that the current market price of \$2.50 per bushel of wheat is reasonable. He may want to lock into the current market price for six or nine months ahead, and yet, because of the element of uncertainty in the success of his expansion plan, he may choose to tread cautiously and decide to limit his possible loss to a small amount but still be able to reserve the price level for the next several months. This he can do by means of buying a call option on, say, ten wheat contracts of 5,000 bushels each, but instead of committing himself to the full price of such a large contract he may decide to pay an option of \$100 per contract. This means he will have limited his possible loss to only \$1000. The basic notion can also operate along similar lines: the buyer risks a small amount of money to give himself flexibility and also to limit his possible losses to a much smaller amount.⁴¹

El-Gārī has upheld that achieving a balance between the two formulas is not difficult. If we assume the presence of a central authority (or several central authorities), such as the stock exchange authority or the clearinghouse that concludes these contracts including one hundred shares, for instance, for a fixed price on the basis of delivering them within a specific period (90 days for instance). Instead of the investor's payment of a price for the option, he may pay a certain percentage of that amount on the basis of advance on the sale. If he feels that it is in his interest to go ahead with the sale during the period of time specified, he may sign the contract. If he feels that this course of action is not in his interest, he will give up his claim to the advance payment. Such a percentage may be raised or reduced depending on the factors of supply and demand. What is paid against the transfer of risk is not the least affected by the fact that such payment is a lump sum or a percentage of a sum known well in advance. Therefore, the formula suggested above is quite appropriate to serve as a model for the call option and

⁴¹ Kamālī, *Islamic Commercial Law an Analysis of Options and Futures*, p. 369.

does not involve any contradiction with the rules and requirements of the *sharī'ah*.⁴²

On the other hand, after quoting parts of Ibn Qudāmah's analysis on *'arbūn*, Vogel and Hayes said, "The discussion shows how closely the *'arbūn* contract can be analogised to the pure call option. It also shows how, if it has been given the right market or institutional framework, an *'arbūn* contract could be devised with results and pricing identical or nearly identical to the call option".⁴³

Accordingly it could be concluded that *'arbūn* could be the Islamic alternative to a call option without contravening *sharī'ah* principles. However, the question remains as to what would be the Islamic alternative to a put option?

'Arbūn as an Alternative to Put Option

The possible alternative to a put option in connection with *'arbūn* is to include a condition in the contract that if the seller fails to fulfill his contractual obligations, he should pay the buyer a certain amount in the form of reverse *'arbūn*. Although the issue has not been directly addressed by the classical scholars, the case of *'arbūn* in *salam* discussed above is somewhat similar to this one.

To give an example of such a transaction and how it is needed, it could be said that a retailer may enter with another into a *salam* contract to purchase 1 million barrels of oil at a price of US\$25 a barrel, which is to be delivered within six months time. The buyer here is hoping that the price of oil in the coming six months will reach US\$30 a barrel. Then, he will take delivery from his counterpart and sell his stock on a retail basis to his client on the spot market to make some profit. He pays the price at the time of contract, as it is stipulated by the majority, or some time later, according to the Mālikīs.

However, four months after the signing of the contract, the buyer realizes that his prediction may not be true due to some external factors, such as weather, which is not as cold as it was in the year of issue and therefore, the demand for oil fell unexpectedly resulting in sharp drop

⁴² See, Mohammad Ali El-Gārī, "Toward An Islamic Stock Market", p. 14.

⁴³ Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, p. 162.

in the price of oil. Or some oil producing countries, due to domestic economic problems, increase their quotas of production which affects negatively the price of oil in the international market which is now US\$23 a barrel and there is even a possibility that it may go down to US\$20. In such a case, the buyer may be willing to rescind the contract and collect his money. After negotiations with the seller, the contract is cancelled and the buyer has relinquished US\$2 per barrel to the seller in exchange for this cancellation. In such a case, the buyer has minimized his loss. Thus, rather than losing US\$5 per barrel, in case he would have taken delivery from the seller on the agreed date, now he is just losing US\$2 per barrel.

Although such a transaction is permissible as a kind of *iqālah* based on what is reported in Muṣannaf ‘Abd al-Razzāq and Ibn ‘Abī Shaibah based on the opinion of the scholars mentioned above and could solve the problem of such a risk partially, it is not sufficient in today’s volatile and complex economic climate. It is quite possible that the seller may not be willing to cancel the contract and consequently the buyer may suffer a huge loss. Thus, to manage such a risk, the buyer may be willing from the beginning to include a condition in the contract to the effect that if the purchaser fails to take delivery, for one reason or another, during an agreed period, he will have the right to rescind the contract on condition that he forfeits to the seller US\$2 per barrel.

Some modern Muslim jurists have addressed this issue. Al-Sanhūrī, for instance, is of the opinion that if the seller, who has already received the ‘*arbūn*, fails to fulfill his obligation, he should return twice the amount of the first ‘*arbūn* as compensation to the buyer.⁴⁴ This opinion has also been endorsed by Rafīq al-Maṣrī who did not see any difference between the original ‘*arbūn* and the reverse ‘*arbūn*. In both cases, the payment is in exchange for the right to cancel the contract or an option with a price. Al-Maṣrī added that by giving this right to both parties, the transaction will be much fairer than just giving it to one party.⁴⁵

However, some other jurists like al-Ḍarīr have rejected the reverse ‘*arbūn* without further analysis on the grounds that such a clause is only discussed under secular legislation and not under Islamic legal works. It should be noted that almost all Arab legislation has opted for the

⁴⁴ al-Sanhūrī, *al-Wasīt*, vol. 1, p. 261.

⁴⁵ Rafīq al-Maṣrī, “Bay’ al-‘Arbūn”, p. 730.

legality of reverse *‘arbūn*, including the Jordanian civil code which is recognized as being based on the principles of Islamic law principles. Thus, al-Sanhūrī tried to prove that the reverse *‘arbūn* is in accordance with Islamic principles. However, according to al-Ḍarīr, al-Sanhūrī did not take the right path in this case.⁴⁶

However, despite al-Ḍarīr’s conclusion, it seems that al-Sanhūrī’s argument is legally well established. Al-Sanhūrī maintained that if Imam Ahmad based his argument on the adoption of *‘arbūn* by drawing an analogy between *‘arbūn* and the legality of the case where a person, who has bought something but after some time wants to rescind the contract, could do so by relinquishing part of the price to the seller. Therefore, based on Imam Ahmad’s analogy, we can say that, as al-Sanhūrī argued, it is possible to give to the seller also the right to rescind the contract and pay the amount of *‘arbūn* twice. Moreover, if it is permissible to give the right to the buyer or the seller to rescind the contract in exchange for something, it is possible to grant it to both of them in a contract at the same time.⁴⁷

Considering this difference of opinion and the absence of any explicit text regarding the issue, we will try to discuss it in line with the general theory of freedom of contract. Thus, it is clear that such a stipulation does not contradict the objective of the contract or any explicit text. Moreover, it is to the benefit of the contract and agreed upon by both parties with their full consent. Therefore, it is a legal condition or clause as Imām al-Shāf‘ī said, “in principle all contracts are permissible if they are concluded with the full consent of the parties unless there is an explicit text from the prophet to prohibit such a sale, or such a prohibition could be understood from the explicit text”.⁴⁸ Similar statements have been echoed from different scholars of the different schools of Islamic law.⁴⁹ Thus, it could be concluded that the reverse *‘arbūn* is legally permissible and could serve as an alternative to a put option.

On the other hand, El-Gārī tried to come up with what could be considered as a similar formula to a put option by suggesting this trans-

⁴⁶ *Mjallat Majma‘ al-Fiqh al-Islāmī*, discussion (about *‘arbūn*), p. 759.

⁴⁷ Abd al-Razzāq al-Sanhūrī, *Maṣādir al-Ḥaq*, Dār al-Ma‘ārif, Cairo, vol. 2, p. 96.

⁴⁸ al-Shāfī *al-Umm*, vol. 3, p. 3; Ibn Rushd, *al-Muqaddimat al-Mumahhidāt*, vol. 2, pp. 61–62.

⁴⁹ See for instance, Ibn Rushd *al-Muqaddimāt al-Mumahhidāt*, vol. 2, pp. 61–62; Ibn Taymiyyah, *Majmū‘ al-Fatāwā*, vol. 29, p. 226; Ibn ‘Ābidīn, *Rad al-Muḥtār*, vol. 4, p. 176.

action may be reached on the basis of the assumption that the contract involves the rendering of a service by a certain party who is holding shares and wishes to sell them. The fee paid for the service rendered, the period and effort are fixed by the investor in agreement with that party. It would not serve the purpose, if that party looked for a buyer as soon as possible. What is required is that a buyer should be found within a certain period (for example 90 days) during which an investor will have the option. The party referred to is some central authority such as the stock exchange administration or a clearinghouse at the exchange or the market maker but not stockbrokers or investors. The function of this party is actually the rendering of this service. Such a party is not a stockbroker who is an agent. The entity should act in a manner similar to the formula of the European rather than the American options.⁵⁰

El-Gārī's proposition seems to be based on the contract of *ijarāh* and *ju'alah*. However, the practical success of the formula as an alternative to a put option needs to be ascertained especially when El-Gārī himself acknowledges that in certain circumstances, (namely when the buy orders fall short of the sell orders), some problems may arise.

Another proposition about a put option is the suggestion by Vogel and Hayes under the concept of the third party guarantee in which a customer can use a bank as a guarantor. The bank would be compensated by an administrative fee paid by the purchaser of the item. To be Islamically acceptable, this fee cannot be stated as a percentage of the value of the contract. In case of default, the bank can seize and sell the item to help satisfy the purchaser's remaining obligations to the seller. From the purchaser's viewpoint, the third party guarantee can be taken as a put option obtained from the bank in exchange for a premium. If at some future time the purchaser concludes that the item is not as valuable as the remaining instalments, he could theoretically stop paying the instalments to the seller and surrender the item to the bank. This is, therefore, a put option with a strike price equal to the remaining instalment payments (as a practical matter however, he can write a provision allowing him to recover from the purchaser any loss thereby suffered). Assuming that the bank sold guarantees to many customers,

⁵⁰ See, Mohammad Ali El-Gārī, "Toward An Islamic Stock Market", pp. 15–16.

its aggregate risk would be reduced through diversification, and it could use collected premiums as a reserve fund.⁵¹

However, if we consider the fact that in conventional options the premium varies according to the forces of supply and demand and the price of the underlying asset, or the fact that the down payment in *'arbūn* also varies according to the purchased item, then the premium in the third party should vary in a similar manner. And if it varies in the same manner, it will no longer be an administrative fee but a price for the guarantee, which, in principle, in order to be legally acceptable should be without a price. Secondly, if the purchaser of the item requests the guarantee from the bank, not because he is in need of such a guarantee but just to benefit in future from the change in the value of the item and the remaining instalments, he will not be acting in good faith whereas, as a matter of principle, in Islamic law all transactions must be concluded and executed in good faith. Despite these remarks, the practical value of the above propositions may not be discounted totally although the present study prefers the reverse *'arbūn* as the alternative to a put option.

It is now worth looking into the points of difference between option and *'arbūn* as postulated by some contemporary Muslim jurists. These objections could be summarized in the following points:

1. An option requires payment for something that is a mere intangible “right”, not property (*māl*) in the usual sense of tangible good or a utility taken from a tangible good, as for this alone compensation can be demanded. Then, the option price is “unearned”.
2. The right of option is given to the buyer as well the seller while *'arbūn* is given only to the buyer. The price of the option is separate from the price of the underlying commodity and one could sell it or give it as a gift, which is not the case in *'arbūn*.
3. The objective of option trading is not the benefit of the contract, where the buyer receives the commodity and the seller receives the price, they, rather, look, for price differentials. Moreover, in the exercise of the option, only one party can gain from the contract while the other must lose. Whether a party will gain or lose depends on unknown future market prices.

⁵¹ See Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, pp. 228–229.

4. In most actual option contracts, the parties have no intention of taking delivery, but only of liquidating their contracts against the price differentials. In every lawful Islamic sale, on the other hand, the parties fix their exchange fully and finally in the present. Thus, the entirety of at least one of the countervalues is at least presently owed, even if not immediately paid.
5. The underlying asset in an option is not only a commodity as it is the case in ‘*arbūn* but it could also be currency or even stock indices, which are a kind of gambling.
6. The price of an option is determined by the movement of interest rates, which is not Islamic.
7. If the option is in currency, not even forward sales are allowed since currencies may be exchanged only on the spot.⁵²

It is clear that the first objection is the most important one. It is directed to the essence of the contract by invalidating its subject matter. However, we will deal with it in the coming chapter in more details.

Concerning the second objection, namely the right to rescind the contract being given to both the seller and the buyer while in ‘*arbūn* it is only granted to the buyer, it could be said that even if this right is guaranteed to the seller, no *ribā* or *gharar* is involved in such a transaction. Moreover, it does not contradict any specific sharī‘ah text. Therefore, it is a legal transaction based on the general theory of freedom of contracts and stipulations. Similarly, the right to option in *khiyār al-sharṭ* was originally guaranteed by text only to the seller but later it was extended, by way of *ijihād*, to the buyer or both of them. Therefore, to extend the right to ‘*arbūn* to the seller as well, is a similar case, as long as it does not contradict a specific text and, indeed, such an extension does not contradict any text. But it is rather a condition that is harmonious with the benefit of the contract and its objectives.

The third objection is that the parties are just looking for price differentials and are not willing to fulfill the objectives of the contract; it could be said that the issue of price differentials has been declared as unlawful by some Muslim scholars who equate it with excessive speculation, which will lead to market instability and then injustice. Moreover,

⁵² Mukhtār al-Salāmī, “al-Ikhtiyārāt”, *Majallat Majma‘ al-Fiqh al-Islāmī*, p. 233; al-Zuhailī, “al-Ikhtiyārāt”, *Majallat Majma‘ al-Fiqh al-Islāmī*, p. 256, ‘Abū Ghuddah, “al-Ikhtiyārāt”, *Majallat Majma‘ al-Fiqh al-Islāmī*, p. 334.

not every issue of price differentials is speculation or excessive speculation. For instance, commenting on the relationship between *'arbūn* and options Rafiq al-Maṣrī said “options are illegal for many reasons among others the objective of the parties is to look for price differentials. We are not saying options are illegal because paying a premium is illegal but because the objective is to look for price differentials which we see it as illegal.”⁵³

From this statement it is clear that al-Maṣrī opposes options not because of the contractual form of options or because the sales of right is not in line with the *sharī'ah* but because the objective of the participants is to look for price differential. However, the issue of price differentials is raised also against other transactions, which are unanimously considered as contractually legal such as the ordinary sale/purchase of shares and commodities unless the buyer has the intention of buying and keeping the shares for some time. Therefore, it is not because of the nature of the contractual form of options but because of the way in which they are traded. Although it may lead sometimes to market speculation, one should not forget at the same time that sometimes it is necessary to solve the problem of liquidity for some genuine traders who want to hedge against possible risk. Moreover, such a stand may lead to the evaporation of the idea of an Islamic market.

We have already elaborated on the issue while addressing the issue of speculation while some of its forms which are closely related to gambling and options are discussed in another section.

Concerning the objection that the underlying asset in options is not only the commodity as is the case with *'arbūn* but it could also be currency and even stock indices which are a kind of gambling, we have already indicated that *'arbūn* could not be used for currency, stock indices or interest rate options trading. Therefore, any objection about the use of *'arbūn* as the Islamic alternative to options should be limited to commodities and shares where there is a possibility of options from an Islamic point of view.

Regarding the point that the price of options is determined by the movement of interest rates, it could be said that in an ordinary *'arbūn* market, there is no possibility of determining the price through interest. Moreover, the alternative to options through *'arbūn* is just limited to the primary market. Therefore, the objection may have some legitimacy

⁵³ Rafiq al-Miṣrī, “Bay' al-'Arbūn”, p. 725.

with regard to the Islamic alternative if it is possible to trade it in the secondary market. Even here it may not be a real effect of interest rate in the Islamic alternative of options as we shall elaborate.

Furthermore, the determination of price in the already approved Islamic modes of investment is not determined by interest rates. Therefore, the determination of price in options would not be an exception. Yet, in cases of determination of the rate of return, the practice of Islamic financial institutions seems to be closely related to LIBOR (London inter bank rate). The response of some leading Muslim economists is that

An equity based Islamic economy does not exist, and a representative rate profit is not available to serve as benchmark for determining the rate of return in secondary modes. The banks have, therefore, no other alternative but to use the LIBOR for this purpose. This makes the secondary modes appear similar to interest-based operations. However even if a representative rate were available, market may not necessarily allow the banks to move away significantly from LIBOR. This is because if they charge a rate significantly higher than LIBOR for their lending, they might lose at least some of the users of their funds to conventional banks. If they charge a rate significantly lower than LIBOR, they might be able to give a lower dividend to their depositors and shareholders thus driving some of them to the conventional banks. Therefore, as long as conventional financial system dominates the world financial markets, Muslims may have to bear with the Islamic banks in their use of LIBOR as an approximate benchmark at least in the initial phase of Islamization.⁵⁴

Thus, it is clear that just to rely on LIBOR in order to determine the rate of return does not put into question the Islamicity of a transaction simply because it is not part of the contract itself. Yet, to determine the rate of return, we have to take into consideration the overall performance of the economic environment we are operating in, which, is dominated by the use of interest rate. Indeed it is almost impossible to do business without taking into account the different factors that affect the business. In a similar observation and response to the criticism that Islamic banks are using interest rate as a criterion for fixing the profit margin in the *murābahah* sales, Sāmi Ḥasan Ḥamoud said:

As a matter of fact there is no known way of avoiding the link with this criterion as long as Islamic banks are operating within an environment where they coexist with traditional banks. But, what is required

⁵⁴ Umar Chapra, “Islamic Banking and Finance: The Dream and Reality”, *Hamdard Islamicus*, Karachi Pakistan, vol. XXII, no. 4, p. 74.

from Islamic banks is to avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods which some of them employ, which involve calculation of the absolute profit rate while paying no consideration to the installments paid during the year.⁵⁵

Similarly, even if the pricing of option in the Islamic alternative is affected by the movement of interest rate, it is not a part of the contract itself but rather a part of the different factors affecting any business activity in the contemporary world or like the effect of LIBOR in determining the rate of return in Islamic bank.

Moreover, it should be noted that among the five factors affecting options pricing, namely strike price, underlying price, time to expiry, volatility, interest rate and time of expiry, interest rates have the least influence on options.⁵⁶

More importantly, the relation between option pricing and interest rate can be taken as an opportunity cost. In order to buy an option, the buyer must borrow funds or use fund in deposit. Either way the buyer incurs an interest cost as it is maintained in the conventional system of option trading. If the interest rates are rising, then the opportunity cost of buying the options increases, and to compensate the buyer premium costs fall. This is because the option writer receiving the premium can place the funds on deposit and receive more interest than was previously anticipated. The situation is reversed when interest rates fall, premium rise. This time it is the writer who needs to be compensated.⁵⁷

It should be noted that in the Islamic alternative there is no possibility of borrowing with interest or depositing in order to benefit from any interest rate rise. Therefore, the effect of interest rate on option pricing is out of context. Moreover, it may be asked why the rate of return in *murābaḥah*, for instance, is not used as a substitute to interest rate. This is because initially the effect of interest rate in option pricing arises due to the fact that the option writer who receives the premium in conventional system of option trading can place the funds on deposit and receive more interest. The Muslim investor, on the other hand, can place the fund in *murābaḥah* investment in order to get benefit. The choice of *murābaḥah* is that although the rate of return in *murābaḥah* is not guaranteed as it is in interest rate but the risk is minimal. Therefore, it

⁵⁵ Sāmī Ḥasan Ḥamoud, "Progress of Islamic Banking: The Aspirations and the Realities", *Islamic Economic Studies*, June 1994, pp. 125–126.

⁵⁶ See The Reuters Financial Training Series, *An Introduction to Derivatives*, p. 88.

⁵⁷ *Ibid.*

could be a substitute to the formula involving interest rate. It is worth noting that even in the conventional system of option pricing, one uses many formulas, not one. The famous mathematical model to evaluate a premium is that developed by Black and Myron Scholes in 1973. However, other mathematical formulas such as the Binominal Theory, the Cox Rubenstein, and Garman-Kohlhan version of Black and Myron Scholes are also used. Therefore, traders in different markets may use different models for pricing options and there is no guarantee that two traders will derive the same premium for the same option.⁵⁸

Therefore, it is argued that if even in the conventional system there is no hundred per cent accuracy about the exact price of an option and there is no guarantee that two traders will derive the same premium for the same option and, if the whole issue is to look for something approximate to reality, then the rate of return in *murābaḥah* could play that role.

On the other hand, the volatility factor which is the measure of the rate of fluctuation of market prices in the underlying instrument is the important factor to be calculated in the option pricing models⁵⁹ which shows that options trading is related to the market of the underlying asset and not in total isolation as it is claimed by some.⁶⁰

The third factor is the underlying price. The premium is affected by the price movement in the underlying instrument. For call option which is the right to buy the underlying asset at fixed strike price, as the underlying price rises so does its premium. Similarly as the underlying price falls so does the cost of the premium. Regarding put option which consists of the right to sell the underlying asset at a fixed strike price, as the underlying price rises, the premium falls and as the underlying price falls the premium cost rises.⁶¹

Concerning the objection that an option incorporates the idea of a future sale, it could be said that the idea of a future sale is accepted by Islamic law in other places such as *al-bay‘ al-mu‘ajjal*, *salam* and *‘istiṣnā’*, therefore, the idea of a future sale in itself could not be a genuine legal ground for objection.

Thus, it is clear that none of these objections against *‘arbūn* as an alternative to options is well founded or genuine and we could conclude

⁵⁸ Ibid., p. 87.

⁵⁹ Ibid., p. 89.

⁶⁰ Ibid.

⁶¹ Ibid., 87.

that it is possible to use ‘*arbūn*’ as an alternative to a call option while “the reverse ‘*arbūn*’” could be used as alternative to a put option.

*Does Options Trading Involve the Combination of Two Contracts
in One Transaction?*

Another objection raised against options is the claim that it constitutes two contracts in one transaction or *bay’atāini fi bay’atin wāḥidah*: the contract to exchange the right to option with the premium and the original contract to buy or sell the commodity shares or the underlying asset.⁶² This claim has been advanced by some scholars like ‘Umar ‘Abd al-Ḥalīm and Samīr Riḍwān. However, this objection is based on shaky foundations. First of all, we agree that there are several genuine *aḥādīth* reported from the Prophet (PBUH) prohibiting the sale of *bay’atāini fi bay’atin wāḥidah* or the combination of two contracts in one transaction. However, none of the interpretations of Muslim jurists given to these *aḥādīth* could be considered similar to the case of options trading. Therefore, it is necessary to mention briefly the different interpretations given to these *aḥādīth* in order to show ‘Abd al-Ḥalīm and Samīr Riḍwān’s misinterpretation. There is a general agreement about the prohibition of such a sale by Muslim jurists but they differ in their interpretation of its nature.

In the first interpretation one says to another ‘I will buy this item from you for ten *dinārs* cash and for 15 *dinārs* if I have to pay one year later’. The seller agrees without identifying in which of the two terms of the deal the contract is concluded. This interpretation is reported from Imām Mālik,⁶³ al-Nasā’ī⁶⁴ and al-Shāf’ī⁶⁵ in one version. There is no difference among Muslim scholars about the illegality of this kind of sale because of the *gharar* in the price, since nobody knows on which of the two terms the contract has been concluded. However, if the parties have chosen one of the two terms for the conclusion of the contract, then, it is a valid contract.

In the second interpretation one says to another ‘I will sell my car to you for 8,000 *dinār* with the condition that you will sell your house to

⁶² ‘Abd al-Ḥalīm, ‘Umar, *al-Iqtisād al-Islāmī*, p. 50.

⁶³ Imām Mālik, *Al-Muwatta’*, vol. 5, p. 39.

⁶⁴ *Sunan al-Nasā’ī*, vol. 7, p. 295.

⁶⁵ al-Nawawī, *al-Majmū’*, vol. 9, p. 321; *Nihāyāt al-Muhtāj*, vol. 3, p. 433.

me for 10,000 *dīnārs*.⁶⁶ This interpretation has been reported from the Ḥanafīs,⁶⁶ Ḥanbalīs⁶⁷ and al-Shāf’ī⁶⁸ in their second opinion.

In the third interpretation the buyer says to the seller, ‘I will buy one of the these cloths from you, for instance, if it is the first, it will be for two *dīnārs* and if it is the second it will be at three *dīnārs*.’ Imām Mālik prohibits this kind of sale on the ground of blocking the means or *sad al-zarā’i* because it is a kind of *ribā*. However, some of his followers objected to his interpretation arguing that this kind of sale should be declared legal and it is part of *khiyār al-ta’yīn*.⁶⁹

The fourth interpretation is reported from Ibn Qayyim who, after rejecting the first interpretation says “it is when someone says to another person I am selling to you this item on deferred basis lasting for one year, for one hundred *dirhams*, for instance, on condition that I will buy it from you immediately after selling it to you now for eighty”. Then he commented that this is the only interpretation of this *ḥadīth* and no other interpretation could be given to it. This interpretation is also in line with the other *ḥadīth* on the issue that, “whoever is involved in such a sale has only two possibilities whether to take the price which is to his disadvantage or take the *ribā*”. Commenting on Ibn Qayyim’s interpretation al-Qaraḍāwī said, “This is the interpretation, which we prefer because it is in line with the objective of the *ḥadīth*, which warns against *bay‘ al-‘īnah* and the use of tricks (*ḥiyal*) which lead to *ribā*.⁷⁰

These are the main interpretations of these *aḥādīth* and the above mentioned concept of sale. However, it is clear that none of them would be associated with options trading and in consequence Samīr Ridwān and ‘Abd al-Ḥalīm’s claim is unfounded.

⁶⁶ Al-Sharakhsī, *al-Mabsūṭ*, vol. 13, p. 16; Ibn al-Humām, *Fatḥ al-Qadīr*, vol. 5, p. 218.

⁶⁷ Ibn Qudāmah, *al-Mughnī*, vol. 4, pp. 233–234.

⁶⁸ Al-Shaf’ī, *al-‘Umm*, vol. 3, p. 67.

⁶⁹ Al-Bājī, *al-Muntaqā*, vol. 5, p. 109; Ibn Rushd, *Bidāyat al-Mujtahid*, vol. 2, p. 154.

⁷⁰ Al-Qaraḍāwī, *Bay‘ al-Murābaḥah li al-‘Āmir bi al-Shirā Kamā Tujrīh al-Maṣārīf al-Islāmiyyah Dirāsah fi Daw‘ al-Nuṣūṣ wa al-Qawā‘id al-Shar‘iyyah*, Makṭabat Wahbah, Cairo, 1987, p. 53.

CHAPTER ELEVEN

THE SALE OF PURE RIGHTS AND THE LEGALITY OF OPTIONS

One of the most commonly cited arguments to invalidate options is the claim that option trading involves the sale of a pure and simple right (*ḥaqq mujarrad*) and such a right is neither a tangible commodity nor a usufruct, therefore, it cannot be a proper subject matter of contract in Islamic law. The issue is at the heart of the legality of options contracts, because if the subject matter of a contract is invalid, the whole contract is invalid since there is no valid contract without a subject matter.

The first part of the above argument that option trading involves the sale of a pure right is correct; and to claim that such a right could not be considered as subject matter of a contract in Islamic law, is misleading. Yet, some early Ḥanafī jurists have defended this opinion based on their *ijtihād* and the economic conditions prevailing at that time. While the other three major schools of Islamic law and the later day Ḥanafī scholars opposed the previous stand. Unfortunately, many contemporary Muslim jurists have opted for the opinion of the earlier Ḥanafī for reasons, which have never been defended by its partisans and which are, at the same time, difficult to understand given the fact that the whole issue of the sale and exchange of rights is based on custom and public interest. On the other hand, some other scholars have opted for the majority view that a right related to property is a usufruct and qualifies as property, but not in relation to options, which is the issue of our study, but in relation to other legal issues based on the sale of right such as intellectual property and copyright. Nevertheless, such opinions may serve as a source of guidance and analogy to our case study.

In relation to the issue of options in particular, only a few scholars have opted for the validity of exchanging such a right for money. Included among these are Kamālī, in his work *Islamic Commercial Law An Analysis of Futures and Options*, Youssuf Sualimān, in his article “Rai’ al-Tashrī’ al-Islāmi fi Masā’il al-Burṣah” followed by ‘Alī ‘Abd al-Qādir’s comments about it and Shahhāt al-Jundi in his book *Mu’āmalāt al-Burṣah fi al-sharī’ah al-Islāmiyyah*.

Kamālī, for instance, argued, “the parties have the freedom to insert stipulations in contracts but also that a monetary compensation or a fee may be asked by one who grants an option or a privilege to the other. If the seller is entitled to stipulate for a security deposit or pawn, then it is a mere extension of the same logic that he may charge the buyer and impose a fee or compensation in respect to such options and stipulations that are to the latter’s advantage...we conclude that options may carry premium and there should be basically no objection to this”.¹ Youssuf Sualimān, ‘Ali ‘Abd al-Qādir and al-Jundī, have advanced similar arguments based on the general theory of freedom of contracts and stipulations.

The Islamic Investment Study Group of the Securities Commission in Malaysia has opted for a similar opinion in one of its reports while discussing the legality of call warrants, arguing that such a right has the characteristics of an asset, which satisfies the concept of *ḥaqq māli* or financial right which is transferable since it could be possessed and one can benefit from it. Thus, Sheikh Azmi Ahmad maintains that after an in-depth investigation, the Islamic Investment Study Group of the Securities Commission approved that call warrant is an instrument within the principles of *sharī‘ah* based on the following factors.

- A call warrant has the characteristics of an asset, which satisfies the concept of *ḥaqq māli*, which is transferable based on the majority view the exception of the Ḥanafī school. Therefore, this right can be classified as an asset and can therefore be traded, possessed and benefited from.
- A call warrant is recognized by *‘urf* as a valuable item within a limited period and can be traded. It has the same characteristics of a coupon by which the holder has the right to buy something within the stipulated time.
- The exercise period and the price of a call are fixed and determined at the time of the issue of the call warrant. This will ensure that the owner of the call warrant will be able to exercise his rights at any time he wishes. When the call warrant is traded in the secondary market, the price will be reflective of market forces of demand and supply. Therefore, *gharar* elements in this contract can be eliminated.

¹ Kamali, *Islamic Commercial Law: An Analysis of Option and Futures*, pp. 356–357.

- Legally there is complete transfer of ownership when the call warrant is transacted. Therefore, the issue of trading before *qabd* does not arise.
- Imam Ahmad has laid the foundation for the terms and conditions of contracts and the Islamic Investment Study Group of the Securities Commission has used it as a guideline for analyzing the call warrant, which is in line with these terms and conditions.
- A call warrant is not the same as buying a right to choose (*ḥaqq al-khiyār*), which is the right given while purchasing goods. On the other hand, a call warrant gives a right and not an obligation to buy a fixed asset.
- *Ribā al-buyūʿ* (sale related *riba*) does not exist in the trading of a call warrant, because it is exchanged for money and not for another call warrant of the same kind.
- Most importantly, the Islamic Investment Study Group held that the underlying asset of the call warrant must be a *ḥalāl* asset and the trading contract must be conducted according to Islamic principles and practices.²

The Islamic Investment Study Group relied also on the report of Nāfiʿ Ibn al-Hārith, caliph ʿUmar’s officer in Makkah to the effect that he bought a prison house from Safwān Ibn Umayyah for the caliph ʿUmar for four thousand *dirhams* on the condition that if the caliph approved it, the deal would be final, otherwise Safwān would return four hundred *dirham*.³ And by what is reported in al-Bukhārī and narrated by Ibn Sirīn that “a man said to a hirer of animals, ‘prepare your travelling animals and if I do not go with you on such and such day, I shall pay you a hundred *dirhams*. But he did not go on that day. Shuraih said: If anyone puts a condition on himself of his own free will without being under duress, he has to abide by it”. Commenting on these two reports, The Islamic Investment Study Group concluded, “this shows that there are practices of paying for the right to buy or to rent something. However, there is no

² See, Sheikh Azmi Ahmad, “Islamic Instruments Study Group: A Report”, paper presented in *International Islamic Capital Market Conference*, Ballroom, Crown Princess Hotel, Kuala Lumpur Malaysia, pp. 8–9.

³ Ibn Qayyim, *Ilām al-Muwaqqiʿin ʿan Rab al-ʿĀlamīn*, vol. 3, p. 389.

dalīl to prove that this right could be transferred. Therefore, the issue is whether this right could be transferred or not”⁴

Although the present study will argue for the same conclusions, that is those of Kamālī and the Islamic Investment Study Group, the above arguments seem to have been based on the general theory of freedom of contract and conditions where the Ḥanbalī position is the most liberal and in line with the objectives of the *sharī‘ah*. Although this principle is fundamental and the primary basis for the legality of selling a right, it seems to be too general to face the huge literature and arguments advanced against the permissibility of selling a pure right. Therefore, more evidences are needed in order to prove beyond reasonable doubt the legality of selling a right. Furthermore, the opponents of the sale of rights advance their arguments depending on the opinion of some early jurists, such as, Ibn ‘Ābidīn, by quoting their statements as evidence for the illegality of the sale of pure rights. Therefore, it seems that it could be effective to prove the opposite from the same sources, namely the early works of Muslim jurists.

On the other hand, it should be noted that the Islamic Investment Study Group has differentiated between the right in a call warrant and the right of *khiyār* in a sale, which seems to be unwarranted if it is meant by *ḥaqq al-khiyār*, in *khiyār al-sharṭ* because the two rights are of the same nature and, therefore, could not be reasonably distinguished from one another.

On the opposite side, namely the stand that options involve the sale of a pure right, which is illegal in Islamic law, and which renders trade on options illegal, we found the participants in the Islamic Fiqh Academy discussion on options adopting a more general stand concerning the sale of pure rights (*al-ḥuqūq al-mujarradah*). For instance, we found Mukhtār al-Salāmī⁵ quoting only the general statement of al-Kāsānī that “pure rights could not be exchanged” itself quoted by Ibn ‘Ābidīn in *Rad al-Muhtar*. Similarly, al-Ḍarīr⁶ has quoted only one passage from *Hāshiyat Ibn ‘Ābidīn* to show that a pure right could not be exchanged. But one may ask if our respected scholars want to limit themselves to just a single quotation from the classical sources of Islamic law to justify their conclusion in such an important and totally

⁴ See, Sheikh Azmi Ahmad, “Islamic Instruments Study Group: A Report”, pp. 7–8.

⁵ Al-Salāmī, “al-Ikhtiyārāt”, p. 235.

⁶ al-Ḍarīr, “al-Ikhtiyārāt”, p. 264.

new phenomenon, why not quoting from the Mālikī school's works, the prevailing *mazhab* in Tunisia and Sudan, the country of al-Salami and al-Ḍarīr respectively and which is the most flexible school in legalising the exchange of rights? However, such an approach may be understood if we put it in the context of importance given to the issue of options as a whole when three out of five of those who presented papers on options acknowledge that they have only prepared a short paper.⁷ Yet, it is logically impossible for a short paper to give the necessary analysis of a topic, which is totally new. ‘Abd al-Wahhāb Abū Sulaimān in his paper, on the other hand, referred to more works concerning the concept of right but his analysis is not convincing. For instance, after reporting the opinion of the Ḥanbalīs in the division of the concept of right, he gives the example of *khiyār al-sharṭ* as an example of rights, which have no relation with property. Then he concluded that the right to option in conventional option trading is similar to that of *khiyār al-sharṭ* and therefore, it could not be the subject matter of a contract and could not be inherited. Moreover, it has no corporal physical existence and therefore, a contract in such a thing will be a contract in a nonexistent thing (*bay’ al-ma’dūm*), which is illegal in Islamic law.⁸

However, such an analysis on the division of the concept of right is somehow inadequate for the following reasons: First of all, it did not refer to the opinion of other schools of Islamic law especially the Mālikīs and Shāf’īs who consider the right in *khiyār al-sharṭ* as a right related to property which therefore, could be inherited. Secondly, even the Ḥanbalī position is not well discussed. They maintained that the right in *khiyār al-sharṭ* could be inherited only if the beneficiary requested that. Does this mean that the request of the beneficiary will transform this right from a right, which is unrelated to property to a right which is so to it? The discussion of the whole issue will be investigated later. Now we are just pointing to ‘Abd al-Wahhāb Abū Sulaimān’s analysis. Furthermore, it seems a little strange for Abū Sulaimān to consider the sale of such a right as a part of *bay’ al-ma’dūm* because it has no physical existence. But what will be Abū Sulaimān’s response to the different cases involving the sale of rights legalized by classical jurists or those legalized by the Fiqh Academy itself, as we will touch on some of them

⁷ *Majallat Majma’ al-Fiqh al-Islāmī*, “al-Ikhtiyārāt”, discussion session, no. 6 vol. 1, pp. 565; 569; 573.

⁸ ‘Abd al-Wahhāb Abū Sulaimān, “al-Ikhtiyārāt”, *Majallat Majma’ al-Fiqh al-Islāmī*, no. 6 vol. 1, pp. 307–308.

later? On the other hand, addressing the issue of the subject matter in a sale contract in the Mālikī school, Abū Sulaimān concluded that the Mālikī position is that the subject matter should be a physical thing and be present at the time of contract whether in reality or at least in a constructive manner (*bi al-quwwah*). However, what will be Abū Sulaimān response to the Mālikī's stance which allows the sale of the right of *shuf'ah* (pre-emption) or other rights legalized by the Mālikī school as we will elaborate later?

Meanwhile, 'Abū Ghuaddah's paper compared the right in conventional options with that of *khiyār al-sharṭ* and concluded that the right in *khiyār al-sharṭ* is not a right related to property (*ḥaqq māli*) and therefore, it could not be inherited or exchanged.⁹

However, it is somewhat amazing to note that Abū Ghuaddah in his book *Al-Khiyār wa' Atharuhu fi al-'Uqūd*,¹⁰ which was originally his doctoral dissertation, concluded that the right of option in *khiyār al-sharṭ* is a right related to property and, therefore, it could be inherited. Yet, we may say he has changed his first opinion since it is normal for a Muslim scholar to change his opinion on a specific issue if he comes across new evidence to sustain the new position. Unfortunately, in his paper on options Abū Ghuaddah fails to bring forward any new evidence to rebut the strong argument he advanced in his early book.

This position has also been adopted in the final resolution of the Academy despite the fact that some of the participants in the discussion have voiced the opposite view. Thus, the resolution read "options contracts as currently applied in the world financial market are a new type of contracts which do not come under any one of the *sharī'ah* nominated contracts. Since the subject matter of the contract is neither a sum of money nor utility or a financial right, which may be waived, therefore, the contract is not permissible in the *sharī'ah*".

This resolution has a great impact on other studies on options later whether by rejecting options from the beginning because a pure right could not be considered the subject matter of a contract since it is not a *māl* or property or by attempting a new alternative, which should not involve the sale of a right. Thus, El-Gārī for instance, maintained that "if we consider the above contract as an independent agreement,

⁹ Abū Qhuddah, "al-Ikhtiyārāt", *Majallat Majma' al-Fiqh al-Islāmī*, no. 6 vol. 1, p. 334.

¹⁰ 'Abd al-Sattār Abū Qhuddah, *al-Khiyār wa' Atharuhu fi al-'Uqūd*, Dallah al-Barakah, Jeddah, pp. 317–325.

that is separate from the sale contract and its subject is a right and an obligation (i.e. a right for the buyer and an obligation towards the seller), then the problem is that in the *shari'ah*, the subject involved is not eligible to become the substance of a sale contract. The said right does not have a tangible and material quality, but it is indeed intangible and may not be sold or bought. It is only similar to a pre-emptive right (*shuf'ah*, right of custody and guardianship) all of which, while allowed in the *shari'ah*, are intangible rights that are not allowed to be sold or relinquished against monetary consideration".¹¹

Vogel and Hayes have also maintained that Islamic law gives little hope for the approval of options contracts. Rather than that, it poses a series of objections of which an option requires payment for something that is a mere intangible "right" (*haqq*) not property (*māl*) in the usual sense (i.e. a tangible good or utility taken form a tangible good) as to which alone compensation can be demanded. This is one basis for the objection of some scholars that option price is unearned".¹² A similar stand has been taken by other writers.¹³

Thus, given the above-mentioned facts, the present study will try to discuss the different opinions on the issue from the different classical sources of Islamic law in regard to whether a *haqq* is considered as property or not and how, and to examine the positions of the different schools of Islamic law. More importantly, since there is no specific verse or *hadīth* on the issue, we need to ascertain what the legal bases are for the legality or prohibition of selling a pure right. At the same time, the present study will try to identify the general principles of what should be considered or not as a *haqq māli* or a financial right in Islamic law based on the treatment of previous Muslim scholars of the different issues involving the exchange and sale of rights.

Thus, we look first into the concept of property or *māl* in the different schools of Islamic law and how the concept of property or *māl* adopted by the early Ḥanafī scholars is proven to be inconsistent and

¹¹ El-Gārī, "Towards an Islamic Stock Market", p. 13.

¹² Vogel and Hayes, *Islamic law and Finance*, p. 164.

¹³ See for instance, Osman Babikir Ahmed, *Islamic Financial Instruments to Manage Short-Term Excess Liquidity* Islamic Research and Training Institute Islamic Development Bank, Jeddah Saudi Arabia, Research paper, no. 41, p. 30; Fuad al-Omar & Mohammed Adel-Ḥaqq, *Islamic Banking Theory, Practice & Challenges*, Oxford University, 1996, p. 92; Tariqullah Khān, *Islamic Financial Derivatives*, Discussion Forum, Islamic finance net. P. 4; Obaidullah, "Financial Engineering with Islamic Options", p. 76; Abd al-Ḥalim Omar, *al-Iqtisād al-Islāmī*, p. 50.

consequently rejected by the later Ḥanafīs or modified through the introduction of many exceptions to it due to the change of custom. In addition, we will briefly study the sale of *khiyār al-shart*, the right of *shuf'ah* (pre-emption) and the inheritance of these rights. Besides, we will look into other rights accepted as property or *māl* and their similarities to the right to buy or to sell a conventional option. Thus, we will examine *badal al-khulu* (or the right to sell the right of tenancy to a third person), the sale of intellectual property (*al-'Ism al-tijārī*), *al-nuzūl 'an al-wazā'if* (the right to sell one's right to resign from a post in exchange for financial remuneration or reward), the right to stop bargaining in a specific commodity in exchange for money and similar cases.

It is worth noting that the issue of custom is at the center of the debate on the sale of rights. Therefore, a brief account of custom and *maṣlahah* as sources of Islamic law is necessary to lay down the legal foundations for the sale of rights in general and the right to option in particular.

Concept of Māl or Property

Three major schools of Islamic law, namely the Mālikī, Shāf'ī and Ḥanbalī are of the opinion that usufructs or *manāfi'* are properties or *māl* and could therefore, be subjected to contractual exchange similar to physical property (*'ayn*). Thus, the Shāf'ī defined property as what we can benefit from... whether it is corporeal (*'ayn*) or usufruct (*manfa'ah*).¹⁴ Similarly, al-Nawawī defined it as “everything that has a benefit and therefore, could be exchanged”.¹⁵ Meanwhile, al-Suyūti said, “the title of property could be attributed to what has a value, could be exchanged and, if one destroys it he will be held liable, however, little it is and, people will not reject it”.¹⁶

Commenting on this definition, al-Duraynī said that it is clear from this definition that custom is the basis for considering something as property. Al-Suyūti has also said, “the title of property could be attributed to what has a value”. This means it has a value among people by custom and becomes the subject matter of exchange. It is logical to

¹⁴ Al-Zarkashi, *al-Qawā'id*, p. 343.

¹⁵ al-Nawawī, *al-Majmū'*, vol. 9, p. 345.

¹⁶ al-Suyuti, *al-Ashbāh wa al-Nazā'ir*, p. 97.

say that everything which has value possessess *manfa'ah* that we could benefit from, because anything which has no benefit would not have a value and therefore, it is not a property and would be thrown away by people. It could be understood from the above definition that the concept of property includes all usufructs (*manāfi'*) and non-corporeal property if it becomes a custom among people to sell it or transact over it. On the other hand, if we realise that the value is the basis for a thing to be a property or not and that the value would be based on *manfa'ah*, we could conclude that *manfa'ah* is the basis of attributing a value to something.¹⁷

Similarly, al-Shāṭibī said: "property is anything which could be possessed and none could claim it from his owner unless by legal means".¹⁸ Commenting on the above definition, al-Durainī said, the legal philosophy of Imam al-Shāṭibī regarding the concept of *māl* is based on the fact that it is a legal attribute (*'itibar, waṣf sharī'*) or the relation of possession between the thing possessed and the possessor. Given that this act of possession is approved by the *sharī'ah*, then it gives the possessor the right of *taṣarruf* or disposal in the object concerned... this legal consideration is the basis for the concept of property in the Mālikī school. It includes corporal and non-corporal property, usufruct and all non-tangible property like "rights", because all right are based on possession and the substance of a right is *ikhtiṣāṣ* competence, power and authority. The *ikhtiṣāṣ* is the substance of possession. Otherwise such "rights" could not be considered rights in the strict sense of the term but just *ibāḥāt* and if the rights could be possessed, rights are properties because property is synonymous with possession in the Mālikī school.¹⁹

Property is also defined as "whatever has a value and could be sold based on this characteristic and whoever destroys (*'i'tadā' alaihi*) it would be held liable".²⁰ In other world it is anything which has permissible benefit like a house, camel, worm and larva for fishing... but any thing which has no *manfa'ah* like an insect or has benefit but is prohib-

¹⁷ al-Duraynī, *Buḥūth Muqāranah fi al-Fiqh al-Islāmi wa Uṣūlihi*, Mu'assat al-Risālah Beirut, 1994, vol. 2, p. 17.

¹⁸ Mohammad Ibn Ibrāhīm al-Shāṭibī, *al-Muwāfaqāt*, Matba'at al-Madani, Egypt, 1975, vol. 2, p. 17.

¹⁹ al-Duraynī, *Buḥūth Muqāranah fi al-Fiqh al-Islāmi wa Uṣūlihi*, vol. 2, pp. 23–25.

²⁰ al-Suyūṭī, *al-Ashbāh wa al-Nazā'ir*, Matbat Muṣṭaphā al-Ḥalabī, Egypt, p. 237; Sharaf al-Dīn al-Maqdisī, *al-Iqnā'*, al-Matb'ah al-Azhariyyah, Cairo, vol. 2, p. 134.

ited by law like wine or allowed under necessity like a corpse or a thing the possession of which would not be allowed unless under dire need is not *māl*.²¹ It is clear that in the Ḥanbalī school like the Mālikī and Shāfī the concept of property is not limited to corporeal property or *‘ayn* since the corner stone is *manfa‘ah* and not the corporeal aspect.

From these different definitions we could say, first of all, that *māl* is anything which has a benefit and could be possessed. Therefore, anything that has no benefit, like some kind of insect, is not *māl*. Secondly, the *manfa‘ah* in that thing should be a *manfa‘ah* which is authorized by the *sharī‘ah*. Hence, the *manfa‘ah* in alcohol could not be considered as *māl* for a Muslim although it is a property for a non-Muslim. Thirdly, the *manfa‘ah* should not be authorized only by way of need like a dog for a farmer for instance, or necessity like a corpse or *maytah*.

However, the early Ḥanafīs defined *māl* as everything that could be physically possessed and one could customarily benefit from.²² However, Ibn ‘Ābidīn, one of the later Ḥanafī jurists defined *māl* as everything which has a value and could be valued by *darāhim* or *danānir*.²³ From this last definition, it is clear that the underlying characteristic of *māl* for the later Ḥanafīs, is the value, which could be assessed or valued in terms of money. Hence, anything which has a value is *māl* and anything which has value is *manfa‘ah* and people would not be accustomed to value something which has no benefit and would not be used as a subject matter of transaction.²⁴ Thus, the concept of *māl* or property for the early Muslim jurists includes all forms of rights, which have certain benefits and to which people are accustomed. Consequently, the right involved in options is a right, which has a benefit since it allows its holder to manage his business risk and people are accustomed to this fact. It has become widespread as a tool of risk management. Moreover, it is not necessary that all people should be aware of this custom, since the custom of traders in one city could be considered as a genuine custom then, a custom, which is internationally recognized may also be considered valid.

²¹ Ibn Qudāmah, *al-Mughnī*, vol. 5, p. 439.

²² Al-Sarakhsī, *al-Mabṣūṭ*, vol. 11, p. 78; Ibn Nujaym *al-Ashbāh wa al-Nazā‘ir*, vol. 2, p. 209.

²³ Ibn ‘Ābidīn, *Ḥāshiyat Rad al-Muḥtār ‘alā al-Dur al-Mukhtār*, Muṣṭaphā al-Ḥalabī, 1966, Egypt, vol. 1, p. 11.

²⁴ For more details see ‘Ajil Jāsīm al-Nashmī, “Al-Huqūq al-Ma‘nawiyah Bay‘ al-‘Ism al-Tijārī”, *Majallat Majma‘ al-Fiqh al-Islāmī*, no. 5, vol. 3, 1988, pp. 2303–2309.

Besides the fact that the general definition of property in the works of early scholars includes rights, it is necessary to refer to some of the cases legalized by Muslim jurists in which the subject matter of sale is a right.

Haqq Al-Nuzūl ‘An Al-Wazā‘if and the Sale of Rights

It is generally agreed in Islamic law that if someone has been appointed to manage the *awqāf* property or to be *Imām* or *mu‘azzin* in a mosque built under *awqāf*, he has the right to stay in his post for as long as he lives. At the same time, he has the right to relinquish this right and resign at any time he wishes. The question is, is it lawful for him to relinquish his right to another person in exchange for something, or in exchange of a specific amount of money? In other words, is it possible to exchange this right for some money?

Since the issue of exchange here is a right, the Ḥanafī jurists have different opinions. The early Ḥanafī scholars considered it as pure right and therefore, it could not be exchanged and if someone gives some money to someone else in exchange for such a right, it would be a kind of corruption. Ibn Nujaym, for instance, argues, “It is illegal to exchange a pure rights like the right of *shuf‘ah* for something and by way of analogy we could say it is illegal to exchange the right to hold his post in the *awqāf* for something of value”. However, the late Ḥanafīs reversed this stand and considered it as legal based on the custom prevailing at that time. However, Ibn ‘Ābidīn, one of the later Ḥanafī jurists, while endorsing the legality of exchanging such a right with something, rejected the argument that such an exchange is based on custom or that it is similar to the right of *shuf‘ah*. He argued that the right of *shuf‘ah* is allowed by the *sharī‘ah* to prevent harm, which may be inflicted upon the owner of this right if an undesirable person becomes his neighbour or his partner. However, such a right is different from that of *ḥaqq al-nuzūl ‘an al-wazā‘if*. Therefore, the analogy between the right for *shuf‘ah* and the right in *ḥaqq al-nuzūl ‘an al-wazā‘if* is a discrepant analogy. The right in the case of *al-nuzūl ‘an al-wazā‘if*, Ibn ‘Ābidīn argues, is a right which has been acquired by its owner, as a mater of principle and therefore, it is lawful to exchange it for something of value.

It seems that Ibn ‘Ābidīn has been forced to reverse Ibn Nujaym’s analogy between *ḥaqq al-nuzūl ‘an al-wazā‘if* and right of *shuf‘ah*

because he acknowledged that both rights were pure rights on one hand, and on the other hand, the prevailing custom at his time necessitated the permissibility of exchanging *ḥaqq al-nuzūl* 'an al-wazā'if and not that of *shuf'ah*, therefore, he had to look for other grounds to differentiate between the two rights. Thus, he argued that the right of *shuf'ah* is allowed by the *sharī'ah* to prevent the harm which may be inflicted on the owner of this right if an undesirable person becomes his neighbour or his partner while such a right is not present in case of *ḥaqq al-nuzūl* 'an al-wazā'if. Importantly, Ibn 'Ābidīn concludes his analysis by saying "Overall, the issue is debatable and there is room for research in analogous and similar cases in this regard.²⁵ Besides, like the later Ḥanafīs, the legality of exchanging the right of *ḥaqq al-nuzūl* 'an al-wazā'if is also reported from other schools of Islamic law.²⁶

The objective of this elaboration is to show that the subject matter of the contract in the above exchange is a pure right but the major schools of Islamic law accept it as legal. More importantly, the right in this case is not related to the sale of any other property. Thus, al-Duraynī, while criticising the Ḥanafīs' objection to the sale of other rights, asks "how they have admitted the right in *ḥaqq al-nuzūl* 'an al-wazā'if as a right, which could be exchanged despite its weakness and rejected the exchange of other rights obviously related to property?"²⁷

Therefore, it could be said if such a right is admitted to be exchanged although it is a pure right and not related to a property based on the prevailing custom at that time, then, why could the right in option, which is related to property not be exchanged? The right in *ḥaqq al-nuzūl* is admitted to be exchanged based on custom, because there is no text to prohibit it and people were in need of it at that time. Similarly, there is no text which prevents the exchange of the right in option and people are in need of it nowadays and Muslim economists acknowledge its benefits. Then, it could be concluded that it is lawful to exchange the right in option on the grounds upon which the right in *ḥaqq al-nuzūl* is legalized.

²⁵ Ibn 'Ābidīn, *Ḥāshiyat Rad al-Muhtār 'alā al-Dur al-Mukhtār*, vol. 4, p. 520.

²⁶ See for instance, al-Mirdāwī, *al-Insāf*, vol. 6, p. 478; al-Buhūtī, *Kashshāf al-Qinā'*, vol. 4, p. 216; *Sharḥ Muntahā al-Īrādāt*, vol. 2, p. 464; *Mawāhib al-Jalīl*, vol. 4, p. 224.

²⁷ al-Duraynī, *Buḥūth Muqāranah fi al-Fiqh al-Islāmī wa 'Usūlihi*, vol. 2, p. 56.

Huqūq Al-Irtifāq and the Sale of Rights

Another aspect of the sale of rights accepted by Muslim jurists is the rights of easements (*irtifāq* or *huquq al-irtifāq*). It is a right guaranteed for the benefit of a house by the neighbouring house or by the owner of a house to the owner of the adjacent house to pass through his house for access, to let the water flow through it or to build a second story on the roof of the first house. This right includes different types of subsidiary rights such as:

1. The right of passage (*ḥaqq al-murūr*): it is a right of passage guaranteed to the owner of a house who has no immediate access to the road unless he crosses through the property of another person. In other words, it is the right to pass through the property of another person.
2. Right of flow (*ḥaqq al-masīl*) or the right of the owner of a house to the flow of water and rain water of his house through another house. It should be noted that in both of the above cases, the property at issue, through which the one who has the right of *murūr* or *masīl*, is under the ownership of another person and, he has only the right to pass in *ḥaqq al-murūr* and right to let the water flow in *ḥaqq al-masīl*.
3. *Ḥaqq al-shūrb* or the right to have a share in a stream of running water.
4. It includes also the right of *ta'allī* or the right of a person to build a house over the house of another person if he gets this right by buying it from the owner of the original house. By law, a person has full right on what is above his house up to the sky and therefore, he could give it or sell it to another person.

In short, we are not concerned here with the different legal implications of these rights or their forms and categories or their usefulness in modern times. Our concern is just limited to the possibility of independently selling these pure rights. And if the pure rights in *ḥuqūq al-irtifāq* could be sold, then why should there be any objection to the sale of the right to option in conventional options trading on the ground that the subject matter is a pure right?

The majority of Muslim scholars are of the opinion that these rights of easement are rights related to property and therefore, they could be sold. However, the Ḥanafis have some difference of opinion within

their school. They agree with the majority that these rights could be sold if they are subordinated to physical property and not as independent because these rights are pure rights or *ḥuquq mujarradah*. While some other Ḥanafis acknowledge that these rights could have a price independently.

The following articles of the *Majallah* may reflect the practical necessity of selling them separately. First of all, article 216 stated that it is lawful to sell the right of passage (*ḥaqq al-murūr*), a right to take a portion of running water (*ḥaqq al-shūrb*) and the right to flow (*ḥaqq al-masīl*) as a part of selling the land itself as is the case of *ḥaqq al-murūr* and *ḥaqq al-masīl* and the sale of water as subject to the water pipes and not independently.

However, article 1168 stated, “when there is a house owned jointly by two persons, and another person has a passage over it, if the owners of the house decide to partition that house, the owner of the passage could not prevent them. But when they have partitioned the house, they should forgo the right of passage as it was before. And if, with the consent of the three, the road is sold together with the house and if the road is owned in common among the three, the price is divided among the three. If the ownership of the road, subject to the right of passage, belongs to the owner of the house and if the other person only has a right of passing over it, everyone takes that of which he has a right. Thus, the land with the right of way is valued first, and then it is valued without the right of way. The excess of the one over the other of the two, belongs to the man who has the right of way, the remainder, falls to the owner of the house”. It is clear from this article, ‘Ali Ḥaydar argues that the right of way or *ḥaqq al-murūr* is given a separate price. As it has been stated before, the issue is disputed in the Ḥanafī school.²⁸

What is important here is that despite the fact the right in *ḥuquq al-irtifāq* is recognized as a pure right, it can be sold and this is the opinion of the majority of Muslim jurists. Hence, the claim that the right in options trading could not be exchanged because the subject matter in options is a right is unfounded.

²⁸ See Ali Haydar, *Durār al-Hukkām Sharḥ Majallat al-Aḥkām*, Dār al-Kutub al-‘Ilmiyyah Beirut, vol. 1, p. 165 & vol. 3, pp. 182–185.

Badal Al-Khulu and the Sale of Rights

Another aspect of transaction, where the subject matter is a right, is known in Islamic law as *badal al-khulu*. It is a sum of money paid by a person to another in exchange for the transfer of his right to the *manfa'ah* (usufruct) of a commercial place, which he has rented from a third person. This kind of exchange has several forms.

Firstly, the owner of a specific land in the market, for instance, has the intention to build a shopping complex on it but he does not have enough money to implement the project. He contacted several persons who have the intention to be the first person to rent the expected shops or commercial places in this complex to provide him with the necessary amount of money to undertake the project. However, when the project is completed, they would be given the expected shops at a lower rental than the prevailing rate and for a specific duration as it would be agreed between the parties. In this example the owner of the place is selling his right to rent the places to anyone he likes among those who provided him with the necessary funds in exchange for their help. For their part those who have provided the funds have provided them in exchange for the benefit to use in the shop lots as agreed between the parties. Moreover, they have full right to transfer or sell this right to a third person during the agreed period with the real owner of the place. What is important here is that such a transaction involves the sale of a right and it is recognized by the different schools of Islamic law including the Ḥanafis as a valid transaction.²⁹

The second aspect of *khulu* is when the person who is staying at the shop has lawfully acquired the *khulu*. Later on, the owner of the place wants to use the place himself or for any other purpose during the period of the tenancy agreement. The owner of the *khulu* has full right not to vacate the place unless the owner of the place gives him something as a price in order to relinquish his right of staying at the place until the end of the agreed duration. For instance, he may have paid RM 1000 as price for the right to acquire the *khulu* at the beginning and now the owner of the place wants to use the commercial place himself and requests the owner of the *khulu* to vacate the place. The owner of the *khulu* could ask now for RM 3000, for instance, from the owner of the

²⁹ See Ibn 'Ābidīn, *Hāshiyat Rad al-Muhtār 'alā al-Dur al-Mukhtār*, vol. 4, pp. 14–16, al-Buhūti, *Maṭālib 'ulī al-Nuhā*, vol. 4, p. 370.

house in exchange for relinquishing his right to stay at the place until the end of the agreed upon duration between the parties before.³⁰

The third aspect of *khulu* is about a person who acquired the *khulu* by legal means in the first place. He has a full right to sell his right of *khulu* to any person and at whatever price he likes. Similar to this is the case where a person has no *khulu* in the place; however, he has rented it by legal means which would entitle him to sell his right to stay at the place to a third person. For instance, a person has rented a commercial place at RM 2000 per month for 12 months. After using the place for seven months, for instance, a third person came and requested him to rent him the place for the remaining 5 months. The one who has rented the place at RM 2,000 per month could rent it to the third party at RM 3,000 per month for the remaining 5 months of his initial period and a third person could rent it from the second for three months, for instance, at RM 3,500 per month. Here again the subject matter of the transaction is not the commercial place itself, but the right to stay in it for a specific period. In other words, the subject matter here is a pure right but all schools of Islamic law consider it as a legal transaction.³¹

On the other hand, it should be noted that this kind of exchange has no precedent in the early Islamic legal system. The first scholar, who gave a *fatwā*, about the issue was Nāṣir al-Dīn al-Laqqānī from the Mālikī school, on the grounds of prevailing custom in Egypt at that time since the legality of such a transaction did not contradict any specific legal text. Subsequently, the *fatwā* was adopted by other schools of Islamic law³² including the Ḥanafīs based on custom³³ although according to their general principles such a *manfa'ah* could not be sold because it is a pure right.

Thus, if the right in *badal al-khulu* was admitted to be exchanged based on custom and the general principles of Islamic commercial

³⁰ For more detail see Mohammad Sulaimān al-Ashkhar, “*badal al-khulu*”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 4 vol. 3, pp. 2187–8

³¹ See for instance, al-Dasūqī, *al-Sharḥ al-Kabīr*, vol. 3, p. 467; al-Zurqānī, *Sharḥ al-Zurqānī 'alā Khalīl*, vol. 7, p. 75; al-Zuhailī, “*badal al-khulu*”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 4, vol. 3, pp. 2173–7; Ibrāhīm Fādīl al-Dabū “Ḥukm al-sharī'ah fi badal al-khulu, al-Sarfaqaliyyah”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 4, vol. 3, pp. 2199–2219; Muḥyī al-Dīn Qādī, “*badal al-khulu fi al-fiqh al-Islāmī*”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 4, vol. 3, pp. 2223–2271; Muhammad 'Alī al-Taskhīrī, “*badal al-khulu wa Taṣḥīḥī*”, *Majallat Majma' al-Fiqh al-Islāmī*, no. 4, vol. 3, pp. 2275–2279.

³² See al-Buhūti, *Matālib ulī al-Nuhā*, vol. 4, p. 370.

³³ See Ibn 'Ābidīn, *Hāshiyat Rad al-Muhtār 'alā al-Dur al-Mukhtār*, vol. 4, pp. 14–16. Ibn Nujaym, *al-Ashbāh wa al-Nazā'ir*, pp. 113–114.

law, even without any precedent in the works of previous scholars and despite the fact that it is an exchange of rights, then why should there be opposition to the sale of the right of option since there is no specific text which prohibits the sale of rights in general or allows the sale of certain rights and disallows the sale of others?

Moreover, it shows that the number of cases where a pure right could be sold is not limited to what is reported from the early Muslim jurists since there is no specific text from the Qur'an or the *ḥadīth* which limits it. The whole issue is based on custom and public interest. It was on these grounds that al-Laqqānī made his first *fatwā* regarding the right of *khulu*, which was followed later by other jurists. Therefore, in modern times as well the legality of selling a pure right should be based on custom and *maslahah*.

Sale and Exchange of the Right of Precedence

It is generally agreed that any person who has precedence in the use of a plot of land which has not been used before by anyone by way of developing it (*ihyā'*) has full right of ownership over it if he has been able to make full use of it. However, if he did not develop it fully but has just made *taḥjīr* over it by marking the land with boundary stones or wooden stakes, the clearing or burning of grass, enclosing the land, digging a trench etc, he has only the right of precedence over the use of this land and not the full right of ownership. Thus, unless he fails to make full use of this land, no one has the right to challenge him in his right of precedence or his possible right of ownership. This is based on the saying of the Prophet (PBUH) "One who rehabilitates a barren land, it is his, and there is no right of expropriation against him".³⁴ However, it is quite possible that after getting the right of precedence over it, he would like to sell it. Does he have the right to sell this right or exchange it for something of value?

Muslim jurists have different views about the issue. Al-Ramly, for instance, said whoever gets precedence over the use of some land and has already erected some woods or assembled some dust on it and, he is financially capable of making full use of the land and to rehabilitate

³⁴ Sunan Abū Dawūd, Kitāb al-Kharāj, English translation, Aḥmad Ḥassan Lahore, Asraf press, 1984, vol. 2, p. 874.

it, he has the right of precedence over this land... however, the prevailing opinion is that this right could not be sold or given as a gift; it is like the right of *shuf'ah*, as it is maintained by al-Māwardī. In contrast al-Dārimī is of the opinion that such a right could be sold because there is a full control of this right by the owner. Hence, it could be sold.³⁵

Similarly, it is reported in *Takmilat al-Majmū'* that if someone acquired a right of precedence over some land, he could transfer it to another person and, if he dies, it could be inherited by his heirs as is the case with the right of *shuf'ah*. However, regarding the sale of such a right, there are two opinions in the *madhhab*: that of Abū Ishāq is that it could be sold because the owner has full control over it while the prevailing opinion is that it could not be sold because it is similar to the right of *shuf'ah*.³⁶

It thus appears that in the above case at least two leading Shāf'ī scholars, namely Abū Ishāq and al-Dārimī approve the legality of selling such a right. A similar difference of opinion has been reported within the Ḥanbalī school where the prevailing opinion is that it could not be sold while Abū al-Khattāb upheld the legality of selling such a right.³⁷ Moreover, al-Buhūtī held that although the owner of such a right could not sell it as it is the prevailing opinion in the *madhhab*, he could drop it in exchange for something of value (*al-nuzūl 'anhu bi 'iwad*).³⁸ From the above, it is clear that the legality of selling the right of precedence is disputed among Muslim scholars. Although its legality is upheld by the minority; it seems that this opinion is in line with the general principles and there is no specific text to prohibit it.

It was based on such an analysis and through the endorsement of the opinion of the minority that *murābahah lil'āmīr bi al-shirā'* was implemented. In other words, at the beginning it was very difficult for Islamic banks to implement *murābahah* in its original form where the promise between the Islamic bank and the customer should not be binding and the customer shall have the full right to cancel the deal as he wishes. It was a very risky transaction for the Islamic banks. To solve the problem the opinion of Ibn Shubruma from the Mālikī school that every promise is binding was adopted. Yet, it was discovered later that some other jurists also shared this opinion although it

³⁵ Al-Ramlī, *Nihāyat al-Muhtāj*, vol. 5, p. 336.

³⁶ al-Mutī, *Takmilat al-Majmū'*, vol. 14, p. 471.

³⁷ See, al-Mirdāwī, *al-Insāf fi Mas'āl al-Khilāf*, vol. 6, pp. 373–374.

³⁸ See, Al-Buhūtī, *Sharḥ Muntahā al-'Irādāt*, vol. 2, p. 464.

still remained the opinion of the minority. What is argued here is that it is a normal approach in Islamic law to endorse the opinion of the minority as long as it is in line with the objective of the *sharī'ah*. The *fiqh* literature is replete with cases of this nature. Therefore, if the right of precedence, although a pure right, could be sold according to some Muslim jurists, why not the right in option, which is also a pure right related to a property?

Intellectual Property and the Sale of Right

Considering the fact that the sale of pure rights is based on custom and *maṣlahah*, some modern Muslim jurists have accepted certain contemporary issues involving the sale of rights on the above grounds. For instance, the right to sell intellectual property is accepted by the vast majority of contemporary Muslim jurists. What is important for us here is the argument used to validate the sale of such rights. 'Ajil Jāsim al-Nashmī for instance, argues "since the right of intellectual property is the result of intellectual and material efforts emanating from its owner and has proportional presence in the material goods resulting from that effort, it will be a source of competition for that good and give it a reputation. This by consequence will fulfill the objective of the *sharī'ah* by making available the best items for people's consumption. This is a *maṣlahah* recognized by the *sharī'ah*. And if people are accustomed to prefer one kind of trademark to another this is like a *maṣlahah* based on custom. And the *maṣlahah* is a usufruct and a usufruct is a property according to the majority of Muslim scholars from the Mālikīs, Shāf'īs, Ḥanbalīs, the late-day Ḥanafīs as well as the early Ḥanafīs if the transaction realises a *maṣlahah* to the people. Therefore, we can say that intellectual property is a *māl* in Islamic law. And since the right in intellectual property is a usufruct and a valuable property, it is a valid for ownership because people are accustomed to consider it as a property due to the benefit drawn from it. The right in intellectual property is not the objective by itself but rather the *manfa'ah* resulting from it as it is said by al-'Izz Ibn 'Abd al-Salām "the usufruct is the main objective of owning properties"³⁹

³⁹ Al-'Izz Ibn 'Abd al-Salām, *Qawā'id al-Aḥkām, fi Maṣaliḥ al-'Anām*, vol. 2, p. 17.

Therefore, Ajil Jāsim al-Nashmī argues, if it is a custom that people are exchanging intellectual properties, then it is a valuable property, because people would not agree to exchange something, which has no value. Property, as it is defined by al-Shāf‘ī, is that which has a value and could be sold and if one destroys it, he would be held liable and people are not throwing it away”. Therefore, a property is not just a physical item, but it could be a usufruct, and at the same time a physical item may not be considered as a property as in the case of wine for a Muslim. Considering the above arguments, we can say confidently that intellectual property is *māl* or usufruct on the one hand, and a right on the other. Hence, rights are considered property if they originate in property or are related to property.⁴⁰

Similarly, Taqī al-‘Usmānī, in his paper regarding intellectual property concluded that “although intellectual property is a pure right, *ḥaqq mujarrad*, not attached to a material property, (after its registration by the government which requires a lot of effort and gives it its legal aspect through the certificate paper registered in the government records), it becomes like the right associated and fixed in a material item. As such, it becomes like an *‘ain* in the custom of traders. Therefore, it could be exchanged by selling it”. There is no doubt that al-‘Usmānī argues that custom can transfer certain rights, from being abstract rights, to the status of corporeal. And property, as Ibn ‘Ābidīn said, is what people considered as property. This is like energy delivered from power or gas, which was not considered as property before because it has have no material or physical aspect, but it has now become a precious kind of property and there is no doubt about the legality of buying and selling it. This is because of its great benefit although the possibility of taking it into possession is out of reach. However, people are accustomed to the fact that it is a valuable property”.⁴¹ Al-‘Usmānī continues his argument and says, by considering such a custom we are not contravening any text or *naṣṣ* from the Qur’ān or the sunnah although it contravenes the norms of *qiyās* or analogy. However, the norms of *qiyās* could be overruled by custom, as it is explained in Islamic jurisprudence.⁴²

⁴⁰ ‘Ajil Jāsim al-Nashmī, “al-Ḥuqūq al-Ma‘nawiyah, Bay‘ al-Ism al-Tijārī”, *Majallat Majma‘ al-Fiqh al-Islāmī*, 1988, no. 5, vol. 3, 2345–2346.

⁴¹ Muhammad Taqī al-‘Usmānī, “Bay‘ al-Ḥuqūq al-Mujarradah”, *Majallat Majma‘ al-Fiqh al-Islāmī*, 1988, no. 5, vol. 3, p. 2384.

⁴² *Ibid.*, p. 2386.

However, even the assumption that the sale of “rights” and usufruct contravenes the norm of *qiyās* or analogy, as recorded by Taqī al-‘Usmānī, is only according to the Ḥanafī school to which our scholar is loyal. Thus, the investigation of some other contemporary Muslim jurists like al-Duraynī that the sale and purchase of rights is in line with *qiyās* and not against it according to the majority of Muslim scholars.⁴³ The practical result is that there is no limitation to make analogy, for selling or exchanging a right, to the already existing cases of selling or exchanging rights approved by the early scholars.

Even the concept of *ḥaqq mujarrad* may not be applied to the kind of rights discussed here if we consider Fathī al-Duraynī’s investigation that a *ḥaqq mujarrad* could not be disposed of in exchange for something and, therefore, those rights, which could be exchanged are not *ḥaqq mujarrad*.

On the other hand, commenting on al-Qarāfī’s opinion on intellectual property (al-Qarāfī is one of the rare classical scholars who discussed the possibility of selling the right to ideas as he calls it *ijtihādāt*. He concludes that such a characteristic or right cannot be inherited because it is a right related to the intention of the owner and his mind or *ḥaqq mujarrad*. Moreover, the *ijtihād* is a kind of *‘ibādah* and the *‘ibādah* could not be sold). Al-Duraynī said, al-Qarāfī has forgotten the dimension of *‘urf* and value (*qīmah*) in the sale of such rights and since it is recognized internationally that intellectual property has a value by custom, then it could be considered as usufruct or a public interest or *maṣlahah* and there is no evidence from the Qur’ān or the sunnah that usufruct is not property. Moreover, there is no text which defines the concept of *māl* or property in Islamic law. It is commonly known that if juridical truth (*al-ḥaqīqah al-shar‘iyyah*) is not present in the issue of discussion we have to refer to customary truth (*al-ḥaqīqah al-‘urfiyyah*) recognized by the people to serve their interests. When the Lawgiver does not specifically mention something, He wants people to refer to custom, because generally people’s transaction are based on interest and, custom is based also on interest. Thus, although the right in intellectual property is not something corporeal seen and to which we could point out, the benefit in this right could be fulfilled through the place where the right has settled... and we all know that among the characteristics

⁴³ See, Fathī al-Duraynī, *Buḥūth Muqāranah, fi al-Fiqh al-Islāmī wa ‘Usūlihi*, Mu’assasat al-Risālah, Beirut, 1994, vol. 2, p. 37.

of a right related to property one that it could be exchanged for money, and one who destroys it will be held liable, and it could also be inherited. Thus, it is clear that al-Qarāfi has mistaken by considering such a right, as a right that has no relation to property and, therefore, could not be inherited. al-Duraynī continues his comment saying that the above methodology has been applied by some jurists in their analysis about the right of option or *khiyār al-sharṭ*. Those who consider it as an intention and willingness have concluded that it cannot be inherited but those who consider it as part of the contract say it can be inherited.⁴⁴

*Right to Option in Khiyār Al-Sharṭ and Right of Shuf‘ah or
Pre-Emption as Property Rights*

‘Abd al-Wahhāb Abū Sulaimān and ‘Abd al-Sattār Abū Qhuddah, in their papers presented at the Islamic Fiqh Academy’s session on options compared the right in conventional options with that of *khiyār al-sharṭ* and concluded that the right in *khiyār al-sharṭ* is not a property right (*ḥaqq māli*) and, therefore, it could not be inherited or exchanged⁴⁵ while al-Darīr and al-Salami have quoted Ibn ‘Ābidīn’s statement that a pure right, like the right in pre-emption, could be sold.

Before discussing the difference of opinion regarding the exchanging or selling of these rights we have to look into the status of such a right. Is it a right related to property (*ḥaqq māli*) or not? The issue is generally tackled by Muslim jurists in connection with the possibility of inheriting such a right.

Concerning the inheritance of the right of option in *khiyār al-sharṭ*, the Mālikīs and Shāfi‘īs consider it lawful because such a right is a right related to the benefit of a property and, therefore, it can be inherited.⁴⁶ The Ḥanafīs, on the other hand, maintained that such a right could not be inherited because it is a kind of desire, opinion and willingness and such willingness will no longer exist after the death of the beneficiary

⁴⁴ See, Fathi al-Duraynī, *Buḥūth Muqāranah, fi al-Fiqh al-Islāmī wa ‘Usūlihi*, vol. 2, pp. 45–6.

⁴⁵ ‘Abd al-Wahhāb Abū Sulaimān, “al-Ikhtiyārāt” *Majallat Majma’ al-Fiqh al-Islāmī*, no. 6, vol. 1, pp. 307–308; Abū Qhuddah, “al-Ikhtiyārāt”, *Majallat Majma’ al-Fiqh al-Islāmī*, no. 6, vol. 1, p. 334.

⁴⁶ See for instance, al-Nawawī, *al-Majmū’*, vol. 9, p. 222; al-Dasūqī, *Sharḥ al-Dasūqī ‘alā Muqtaṣar Khalīl*, vol. 3, p. 102.

of the option as is the case with his other attributes. Hence, the right of option in *khiyār al-sharṭ* cannot be inherited.⁴⁷

The Ḥanbalis have, on the other hand, considered such a right as inheritable only if the beneficiary has claimed or requested the inheritance of that right before his death, otherwise it cannot be inherited.⁴⁸

This means that in principle such a right cannot be inherited unless the beneficiary requests so. It could also be argued that in principle it is inheritable on condition that the beneficiary requests it.⁴⁹ However, one may ask why the beneficiary of the option would not exercise it himself rather than transferring it to his heir? The answer is that he may want to push his right to option to the final limit of the agreed duration before taking the decision of rescinding the contract or confirming it. Therefore, he may transfer this right to his heir if he does not expect to survive after a critical accident, for instance. This is because although the right to option or the right to *shuf'ah* are related to the intention of the beneficiary, they have proprietary (*māl*) repercussions.⁵⁰

It should be noted that the Ḥanbalī jurists defended only the argument that the right to option is not inheritable and no argument has been advanced for the opinion that it could be inherited if the beneficiary requested for it. Commenting on the Ḥanbalīs' opinion, Abū Ghuddah said, they (the Ḥanbalīs) failed to produce any specific evidence to substantiate their claim that this right could not be inherited except the statement that "if the beneficiary requested, it could be inherited". This is a very weak argument, which does not call for discussion,⁵¹ because the request of a person would not make inheritable what is not inheritable.

In his conclusion, Abū Ghuddah said the strongest opinion is that the right of option is inheritable whether the beneficiary requests for it before his death or not. This is due to the fact that besides the argument of those who consider such a right as inheritable, it is logical to widen the scope of estate or *tarikah* so that it could include everything, which has a great similarity with property, rather than to limit it. This is because in principle everything left behind by the deceased person

⁴⁷ al-Kāsānī, *al-Badā'ī*, vol. 5, p. 264.

⁴⁸ See for instance, Ibn Qudāmah, *al-Mughnī*, vol. 3, p. 518; Ibn Muflīh, *al-Furū'*, vol. 4, p. 91.

⁴⁹ 'Abd al-Sattār Abū Qhuddah, *al-Khiyār wa Atharuhu fī al-'Uqūd*, Dallah al-Barakah, Jeddah, p. 321.

⁵⁰ *Ibid.*, p. 322.

⁵¹ *Ibid.*, p. 323.

should be transferred to his heir with no exception. And this principle should not be overruled except by virtue of undisputed evidence. Moreover, by looking to the right of option, and despite the fact that the Ḥanafīs consider it as an intention and desire, in fact it is a right related to property like that of the option of defect and option of inspection, because the objective of it is to obtain pecuniary benefit. On the other hand, the right to option in *khiyār al-shart* is different from the right to option for a girl who has been married to someone, not by her father, while she is still very young or under age, which is not a right related to property. Moreover, even if we accept the argument that the right of option of stipulation is just a personal attribute or characteristic of the beneficiary, this attribute is closely related to property and it is natural that the attributes related to property should be inherited. The transfer of this right by inheritance is like the transfer of other rights agreed upon by all scholars by *ijma'* such as the right for the buyer to possess what he bought; the right of price for the seller; or his right to ask for a guarantee or collateral (*rahan*).⁵²

Although the Ḥanbalīs did not opt for the clear stand of the Mālikīs and Shāf'īs and allow the inheritance of this right, by allowing its inheritance after the request of the beneficiary, their approach shows that they consider it a kind of property albeit not like other property. This is because of the fact that for something to be inherited it should be a property and since this right is inherited after the beneficiary's request, then it is property.

It should be noted here that some other rights related to the general theory of *khiyārāt* in Islamic law and which are similar to the right of option of stipulation have almost the same ruling and difference of opinion among Muslim jurists. We have, for instance, the option of specification (*khiyār al-ta'yīn*) where a person has bought one of different commodities, say for instance, a car from a car dealer but did not specify the colour of the car that he wants to choose but rather asked for an option of *ta'yīn* (choice) lasting for one week and suddenly he died before the exercise of his right. Can this right be inherited or not? Similar to this is the option of *qabūl* when a person has agreed to sell something to another but the buyer asks for few days before giving his answer of acceptance. Then if he dies before exercising his right could this right be inherited?

⁵² Ibid., pp. 324–5.

It is clear that the cause of dispute here is the concept of property or *māl*. Those who consider rights as property allow it to be inherited, while those who have the opposite opinion on rights disallow it from being inherited.

Regarding the inheritance of the right of *shuf'ah* the different schools of Islamic law⁵³ have taken a similar stand to that taken with regard to *khiyār al-shart* and almost the same line of argument was adopted. Therefore, there is no need to elaborate on it, however, what is important here is that, similar to the case of inheritance of the right of option, the inheritance of the right of *shuf'ah* is admitted by the Mālikīs, Shāf'īs and partially by the Ḥanbalīs. Therefore, if these rights could be inherited because they are rights related to property, then, they could be exchanged as well. Therefore, the right to option of stipulation or *khiyār al-shart* and the right to *shuf'ah* could be exchanged. And if these rights could be exchanged despite the fact that they are pure rights, then the right to option in the conventional options trading could also be exchanged although it is a pure right.

*Sale and Exchange of the Right to Option in Khiyār Al-Shart
and the Right to Pre-Emption or Shuf'ah*

Another generalization adopted by many contemporary Muslim jurists, while addressing the sale of right and in particular in relation to conventional options trading, is to quote Ibn 'Abidin's statement that "a pure right such as the right of *shuf'ah* could not be exchanged". As a result, since the right exchanged in the conventional option is similar to that of *shuf'ah* as a pure right, it could not be exchanged. A thorough investigation shows that the legality of exchanging the right of *shuf'ah* is disputed among early Muslim jurists and there is no text from the Qur'an or the sunnah that shows that it is illegal to exchange such a right. Yet, the majority of Muslim jurists consider it as illegal.⁵⁴ However, it is the norm in Islamic law that the opinion of the majority is not a

⁵³ See for instance, Ibn Qudāmah, *al-Mughnī*, Maktabat al-Jumhriyyah, Cairo, vol. 5, p. 375; Ibn al-Humām, *Sharḥ Faṭḥ al-Qadīr*, vol. 7, p. 446; al-Mirdāwī, *al-Inṣāf*, vol. 6, p. 298; al-Shirāzī, *al-Muhazzab*, Dār al-Fikr, Beirut, vol. 2, p. 283; Ibn Rushd, *Bidāyat al-Mujtahid*, Dār al-Fikr, vol. 2, p. 198.

⁵⁴ al-Kāsānī, *Badā'ī al-Ṣanā'ī*, Maktabat Zakariah Youssuf, Cairo, vol. 6, p. 2719; al-Mirdāwī, *al-Inṣāf fi Ma'rifat al-Rājiḥ min al-Khilāf*, vol. 6, p. 270; al-Shirāzī, *Al-Muhazzab*, Dār al-Fikr, vol. 1, p. 280.

necessarily binding. In the absence of a clear text or *naṣṣ* the opinion which is in line with *maṣlaḥah* and the general principles of the *sharī'ah* should be followed. Therefore, an investigation is needed due to the need in modern commercial transactions for the sale of rights.

Thus, the majority of Muslim scholars are of the opinion that the right of *shuf'ah* cannot be exchanged. Because such a right is allowed in principle to prevent a harm or *ḍarar*, which may be inflicted on the beneficiary of the right of *shuf'ah* whether either due to the presence of a disliked (troublesome) neighbour or to any other harm related to neighbourhood. Therefore, by requesting an exchange for the transfer of this right to a third person, it is clear that the beneficiary will not be suffering any harm from this deal and as a result he should be prevented from making profit from this right. However, the Mālikīs did not see any objection in selling this right after receiving it, because it is an established right, then, it could be exchanged like any other right.⁵⁵ This opinion has also been reported from Abū Ishāq Ibrāhīm Ibn Aḥmad al-Mirwazī, one of the leading Shāf'ī scholars.⁵⁶ So, to claim that a pure right like the right of *shuf'ah* cannot be exchanged is just the opinion of some scholars while others consider it as a right, which can be sold. Therefore, the argument, that the right of option is similar to that of *shuf'ah*, and since the right of *shuf'ah* cannot be exchanged, the right of option also cannot be exchanged is unfounded. In contrast, it will be argued that the right of option in the conventional option trading is similar to the right of *shuf'ah*, which can be exchanged according to the Mālikī school and Abū Ishāq Ibrāhīm Ibn Aḥmad al-Mirwazī from the Shāf'ī school, then, the right to option in the conventional options can be exchanged. Moreover, it is not only the opinion of some Muslim jurists, but it is also in line with the general principle that all things, including contracts and conditions, are permissible and, there is no text from the Qur'ān and sunnah to prohibit the sale of such right. Therefore, it is incumbent upon those who prohibit the sale of such a right to provide the evidence.

A similar case concerning the sale of rights is the possibility of selling or exchanging the right to cancel the contract or to ratify it in *khiyār*

⁵⁵ Imām Mālik, *al-Mudawwah al-Kubrā*, Dār al-Fikr Beirut, vol. 4, p. 216; *Hāshiyat al-Ruhuni 'alā al-Zurqāni*, Dār al-Fikr, Beirut, vol. 6, p. 264; al-Mawwāq, *al-Tāj wa al-Iklīl*, with *Mawāhib al-Jalīl*, vol. 5, p. 318.

⁵⁶ See Al-Nawawī, *Rawḍat al-Ṭālibin wa 'Uddat al-Muttaqin*, al-Maktab al-Islāmī Beirut, vol. 5, p. 111.

al-sharṭ (option of stipulation). The general prevailing opinion is that such a right cannot be exchanged. Al-Ḍarīr, for instance, after comparing *khiyār al-sharṭ* with option, said “although option is somehow similar to *khiyār al-sharṭ*, there are fundamental differences between the two types of sale. Thus, the option in *khiyār al-sharṭ* is part of the contract, while it is totally a separate matter in conventional contracts. Moreover, al-Ḍarīr argues that he did not come across the opinion of any early scholar allowing pecuniary exchange with the option in *khiyār al-sharṭ*.⁵⁷

However, although the general opinion is not in favor of exchanging such a right, we have come across a Ḥanafī *fatwā* allowing such an exchange. It is reported in *al-Fatāwā al-Hindiyyah* and *Fatāwā Qādi Khān* that “if a person sells a house to another with an option of stipulation or *khiyār al-sharṭ* for three days, then the buyer requests the seller to drop his right for option in exchange for a specific amount of money or a specific commodity, such a transaction is legal and the amount added would be considered as an increase in the price of the house. Similarly, if the option is in favor of the buyer and the seller requests him to drop his right for option and confirms the contract, the transaction is legal and it will be a deduction from the initial price.”⁵⁸

From the above *fatwā*, it can be noted that the exchange of such a right is allowed by scholars from the Ḥanafī school which did not consider such a right as a right related to property. So, it could be said that although the Ḥanafīs did not consider such a right as a right related to property and therefore, it could not be exchanged, this will be part of the many exceptions they have made to their general principles about the exchange of rights, as is the case of *ḥaqq al-nuzūl* ‘*an al-wazā’if*’ or *huquqq al-irtifāq* based on custom and the need of people for such transactions. Hence, it is quite possible that the Ḥanafī scholars who allowed the exchange of the right of option in *khiyār al-sharṭ* based their opinion on custom and the need for such an exchange.

A similar analysis was made by ‘Abd al-Raḥmān al-Sa’dī, a prominent modern Ḥanbalī scholars, while addressing the issue of *ṣullḥ* or reconciliation to drop one’s right in pre-emption or *shuf‘ah* and the

⁵⁷ Ṣiddīq al-Ḍarīr, “al-Ikhtiyārāt”, *Majallat Majma‘ al-Fiqh al-Islāmī*, no. 6, vol. 1, p. 263.

⁵⁸ al-Fatāwā al-Hindiyyah, Dār ‘Ihyā’ al-Turāth al-‘Arabī, Beirut, 1986, vol. 3, p. 45; *Fatāwā Qādi Khān*, Mawlawi Niyaz Muhammad Kuwanti, Bulishistan, 1985, vol. 2, p. 371.

right of option of stipulation or *khiyār al-shart* in exchange for money. He stressed that the *ḥadīth* of the prophet that, “*ṣulḥ* or reconciliation among Muslims is legal unless it prohibits what is allowed or permits what is prohibited by the *sharī‘ah* is general to any kind of *ṣulḥ* as long as it does not include something prohibited, *ribā* and does not contravene an obligation or *wājib*. To drop one’s right in pre-emption or *shuf‘ah* or right of option of stipulation or *khiyār al-shart* in exchange for money is similar to that. And their argument (the early Ḥanbalīs) that these rights are not legalized for financial benefit is true, but a person may accept to drop or relinquish his right in pre-emption or *shuf‘ah* and the right of option of stipulation or *khiyār al-shart* in exchange for money and he may not agree to relinquish his right without that . . . and such an exchange is in line with the general principles and there is no explicit evidence which prohibits its exchange.⁵⁹

Similarly, ‘Ali al-Khafif, while touching on the different opinions about the sale of right of pre-emption or *shuf‘ah*, maintained that the majority disallows its sale while many scholars of the Mālīkī school consider it lawful. Then he commented after the Mālīkī opinion saying “there is no doubt this is clear (in its argument) while the Ḥanafī opinion that such a right could not be sold is questionable”.⁶⁰ This is despite the fact that ‘Ali al-Khafif, is generally influenced by the Ḥanafī’s school in his writing.

More importantly, if we apply the principles adopted by the Mālīkīs and the Shāf‘īs that the right of option in *khiyār al-shart* and the right in pre-emption or *shuf‘ah* is a right related to property as we have already explained, we could say that to allow exchange of a such right for money or property when there is a need for such an exchange is in line with the principles adopted by the Mālīkīs and Shāf‘īs in this regard. Although we did not come across an explicit opinion from the two schools on the matter, this does not mean it is against the principles of these two schools. It could also be argued that probably the exchange of such a right was not a custom in the Mālīkī and Shāf‘ī dominated areas at the time of early Muslim jurists and not because it is against the general principles of the two schools. And if some scholars from

⁵⁹ See, ‘Abd al-Raḥmān bin Nāṣir al-Sa‘dī, *al-Mukhtārāt al-Jaliyyah min al-Masā’il al-Fiqhiyyah*, al-Ri‘āṣah al-‘Āmmah li Idārāt al-Buḥūth al-‘Ilmiyyah wa al-Da’wah wa al-Irshād, Saudi Arabia, 1985, p. 148.

⁶⁰ ‘Ali al-Khafif *Aḥkām al-Mu‘amalāt al-Shar‘iyyah*, Dār al-Fikr al-‘Arabī, Cairo, 1996, vol. 3, pp. 171–172.

the two more conservative schools, namely the Ḥanafī and Ḥanbalī schools, regarding the issue of considering the right of option and the right of pre-emption as rights related to property, allow the exchange of such rights for money, then to allow such an exchange based on the principles of the Mālikīs and Shāf'īs is much clearer.

Thus, we can say: to exchange a pure right such as the right in option of *khiyār al-sharṭ* is in line with *sharī'ah* principles because it is a right related to property. Hence, there are no legal grounds to invalidate the exchange or the sale of option in conventional options contracts because options are similar to *khiyār al-sharṭ* and since the option in *khiyār al-sharṭ* cannot be exchanged, it will be so with the right in conventional options.

Exchange of Right to Bargain for Purchase of Commodity

In a similar approach to the preceding cases, the Mālikīs allow exchange of one's right to bargain with others in the purchase of a specific commodity in exchange for money. Thus, when two persons, for instance, are bargaining for the purchase of a specific commodity and one of them requests the other to stop bargaining with him in exchange for two dīnārs, or offers him, for instance, the opportunity to be his partner in the ownership of the commodity, the one who stops bargaining has full right to get this money, whether the contract has been concluded with the commodity's owner or not. The same ruling according to the Mālikīs can also be applied to a situation where some people are contesting for the marriage of a woman or getting a specific job and one of them requests the other to stop competing with him in exchange for some money.⁶¹ The above cases show once again that a pure right could be exchanged with money and there is nothing, which prohibits that.

Besides the above cases of rights, which can be bought and sold, there are a number of rights which cannot be bought and sold naturally, however, they can be dropped in exchange for something. Although dropping is not hundred per cent selling, it shares its meaning. That is why some jurists have even used the term selling in its figurative

⁶¹ See al-Dasūqī, *Ḥāshiyat al-Dasūqī 'alā al-Sharḥ al-Kabīr*, Dār 'Ihyā' al-Kutub al-'Arabiyyah, Cairo, vol. 3, p. 68; al-Ḥattāb, *Mawāhib al-Jalīl Li-Sharḥ Mukhtaṣar Khalīl*, Dār al-Fikr, vol. 2, p. 378; *Al-Khirshī 'alā Mukhtaṣar Khalīl*, Dār al-Fikr, vol. 5, p. 83; Muhammad 'Uleish, *Sharḥ Minaḥ al-Jalīl 'alā Mukhtaṣar Khalīl*, vol. 2, p. 573.

sense. What is important is that a pure right can be sold or dropped in exchange for money.

Sale of a Right By a Wife To Have Her Husband With Her

In line with the previous difference of opinion in considering what rights can or cannot be exchanged for, the majority of scholars consider it illegal for a woman who is sharing a husband with another woman (under a polygamy system) to exchange her right of having her husband with her for money so that he could be with his second wife. However, the Mālikīs maintain that the husband of three wives for instance, can buy (the expression used by ‘Ulesh but in reality the right is dropped but the term “buy” is used in a figurative sense) “the day (s)” of one of his wives and give it to whom he likes. But ‘Ulesh added the duration should not be too long for fear of *gharar*. It should be noted that considering the fact that Islam allows polygamy, a polygamist should divide his nights among his wives in a just and fair manner, two nights with each one of them for instance. However, the Mālikīs allow such a right to be dropped in exchange for money.⁶² Similarly, Ibn Taymiyyah argues that by analogy to similar cases adopted in the Ḥanbalī school, such a right could be exchanged like other rights.⁶³ Once again this is a case where a pure right is exchanged for money in confirmation to the maintained hypothesis that the exchange or sale of rights is in line with the general principles of Islamic law.

Earning an Exchange For Waiving the Right To Hadānah

It is possible to waive the right to *ḥadānah* in exchange for money in the Ḥanafī and Mālikī schools because it is an established right and therefore, its owner can make use of it. For instance, if a woman wants to make *khul’* (divorce in return for a monetary compensation to be paid by the wife to the husband) from her husband from whom she has already a child and she does not possess the necessary amount of money to pay for the *khulu’*, she can waive her right to *ḥadānah* or

⁶² ‘Ulesh, *Sharḥ Minaḥ al-Jalīl ‘alā Mukhtaṣar Khalīl*, Dār Sādir, vol. 2, p. 174.

⁶³ See, al-Buhūtī, *Kashshāf al-Qinā’*, vol. 5, p. 206.

custody of her child after the divorce in exchange for getting the *khul'* from her husband.⁶⁴ It should be noted however, that even those who have argued against such an exchange maintained that the right to custody does not belong to the mother as it is maintained by the first group but rather to the child, and therefore, the mother could not drop it in exchange of something.

Earning an Exchange For Waiving a Right

There is a difference of opinion among the different schools of Islamic law concerning the right to recover one's gift after giving it to someone. The Ḥanafīs are of the opinion that the gift donor has the right to get it back. The gift receiver, according to the Ḥanafīs, can give the gift donor something in exchange for dropping his right to get back to his gift.⁶⁵ It could be argued here that what the gift receiver gives to the gift donor in order to drop his right to recover his gift is, in fact, the cost of the item given as a gift. But such an assumption will be correct if the parties concerned are considering it a price for the item given or in exchange for dropping the right to recover the gift. Thus, if it is a price, it would be generally according to the market price of the item. But if it is in exchange for dropping the right, a trivial amount might be enough. More importantly, the case is discussed by the jurists as a case of dropping a right in exchange of something and this is our concern here. The above case shows once again that a pure right can be exchanged. Even if it is physically impossible to buy or to sell such a right, it could be dropped in exchange for something.

From the above analysis of the concept of right (*ḥaqq*) or the concept of usufruct (*manfa'ah*), it is clear that the majority of Muslim scholars maintain that a pure right could be property. This is the stand of three major schools of Islamic law, namely the Mālikīs the Shāf'īs, and the Ḥanbalīs. On the other hand, the early Ḥanafīs did not consider such

⁶⁴ Ulesh *Sharḥ Minah al-Jalīl 'alā Mukhtaṣar Khalīl*, Dār Ṣādir, vol. 2, pp. 184–5; *Ḥāsiyat Qurrat 'Uyūn al-Akḥbār Takmilat Rad al-Mukhtār 'alā al-Dur al-Muhtār*, Dār al-Kutub al-'Ilmiyyah, Beirut, 1994, vol. 5, p. 254.

⁶⁵ *Ḥāsiyat Qurrat 'Uyūn al-Akḥbār Takmilat Rad al-Mukhtār 'alā al-Dur al-Muhtār*, pp. 631–638.

rights as property unless they are related to corporeal property such as *ḥaqq al-murūr*, *ḥaqq al-shurb*, *ḥaqq al-masīl* and *ḥaqq al-ta'allī*.

However, the later Ḥanafis, due to practical pressure, have totally reversed the situation and joined the majority by adopting the approach of exception in order to maintain their early principles that a pure right could not be bought or sold. They conceded that some *ḥuquq mujarradah* could be considered as property. Thus, they admitted that *ḥaqq al-nuzūl* 'an *al-wazā'if* and *badal al-khulu'* despite being a pure right, could be exchanged for money. Moreover, some modern jurists such as Taqī al-'Usmānī influenced by the Ḥanafī school admitted that although intellectual property is a pure right, *ḥaqq mujarrad*, not fixed in a material property, after its registration by the government which requires a lot of effort to give it its legal aspect through the certificate paper registered in the government records, it becomes like the right associated and fixed in a material item. Some Ḥanafis went further by allowing the right of option in *khiyār al-sharṭ* to be dropped in exchange for something as it is endorsed by Qādī Khān.

Concerning the inheritance of certain rights considered to be pure rights or *ḥuquq mujarradah*, such as the right of stipulation in *khiyār al-sharṭ* or the right of *shuf'ah*, the majority of Muslim scholars maintained that these rights are inheritable because they are rights related to property *ḥuquq māliyyah*. It is logical to argue that these rights are inherited because they are *ḥuquq māliyyah* and hence, they could also be exchanged.

Yet, as we have discussed early, Qādī Khān has reported the permissibility of dropping such right in exchange of something despite the unpromising Ḥanafī stand on the sale of rights. Similarly, 'Abd al-Raḥmān al-Sa'dī preferred the opinion that the right of option of stipulation and the right of pre-emption can be exchanged. Therefore, it can be argued why similar rights are not allowed to be bought and sold, if there is a need for such transaction, in our time in the form of conventional options at least in the primary market?

On the other hand, even those rights, which cannot be bought and sold due to their nature, can be dropped in exchange of something. Thus, it is possible to exchange one's right to bargain for the purchase of a commodity with some money; for a woman to exchange her right to have her husband with her on her tour; to exchange her right to *ḥadānah* or custody in order to get *khul'* divorce; or for someone to drop his right to hold back his gift in exchange for something of value.

There is nothing in *sharī'ah* that prevents a pure right from being the subject matter of a contract if people are accustomed to it and if such an exchange does not lead to any infringement of other principles of *sharī'ah*.

More importantly, given the fact that there is no single legal text which prohibits a pure right from being the subject matter of a contract, we may easily resort to the principle that all contracts and conditions are permissible or *al-'Asl fi al-'ashyā' al-Ibāḥa* and it is therefore, incumbent upon those who prohibit the sale of right, as it is in the conventional options contracts, to produce the textual evidence that prohibits it. And the text, which prohibits some thing, should be an explicit text without any doubt about it.

Furthermore, a close look at some of the already proven pure rights that could be the subject matter of a contract and the argument of their legality advanced by the scholars shows that their argument is based on custom. Thus, the legality of *al-nuzūl 'an al-wazā'if*, *badal al-khulu* or the permissibility to drop one's right in *khiyār al-shart* in exchange of something is based on custom. Similarly, some contemporary scholars, who argued for the legality of intellectual property, based their argument on the principle of custom. Thus, as al-Duraynī put it "for a right to be related to property and by consequence can be exchanged two basic elements are required: value and custom". Therefore, the right of option in the conventional system is without any doubt a right, which has a value due to its benefit. This is a reality internationally recognized by market participants and become like a specific custom or *'urf khāṣ*. Yet the *'urf khāṣ* is recognized by Muslim jurists as a source of evidence in the absence of a legal text. Therefore, it is not necessary a transaction should be based on a custom that is prevailing in all markets. It is enough that it is recognized in some markets. It should be noted that even the custom of one-city traders is a valid custom. Thus, al-Laqqānī for instance, based his *fatwā* on *badal al-khuku* on the prevailing custom of Cairo.

CONCLUSION

The study on derivatives instruments shows that the admission of derivatives contracts in Islamic finance depends fundamentally on the type of contract used, the subject matter of the contract and the way they are traded. Therefore, totally rejecting or accepting these novel strategies of risk management will be wrong. Despite the fact almost all derivatives instruments are totally new to Islamic financial law, the possibility of admitting some these instruments or finding the suitable alternative for others is very high.

Thus, it is submitted in this study that the forward, futures and options contracts in currencies, interest rate and stock indices are not permissible in Islamic law due to the clear involvement of *ribā* or excessive risk which is a form of *gharar*.

Meanwhile, the accommodation of derivatives contracts in shares trading and especially in commodities into Islamic law does contradict any genuine text. However, the issue has been generally marred, so far, by the methodology which seeks to establish for any new issue, a precedent in the prevalent classical interpretations of Islamic law while totally disregarding any other opinion even if it does not contradict any genuine text and more importantly even if it constitutes the view of some early Muslim jurists. The issue is also affected by the disregard of some fundamental jurisprudential principles such as the issue of *ta'līl* recognized by the majority of Muslim scholars as the norm in the area of *mu'amalāt*.

This methodology is reflected in the latest resolution of the Islamic Fiqh Academy no. 107 (1/12) 23–28 September 2000 which maintained in its rejection of the forward contract in commodity that “if the subject matter in the forward contract is a commodity that need manufacturing, the transaction must fulfill the conditions of *'istiṣnā'*. If does not need manufacturing, then the price must be paid in the spot and the transaction must fulfill the conditions of *salam*. However, if the price is not paid at the spot, the transaction will be illegal because it is a kind of *bay' al-kāli' bi al-kāli'*. On the other hand, if the transaction is just a promise and not binding upon either parties or at least one of

them, it will be permissible.”¹ Similar resolution has been adopted by the seventeenth al-Barakah forum, in December 1999² disregarding the great need for this contract by Muslim businessmen and the different grounds that may constitute a valid foundation for the legality of this contract.

It is maintained in the present study that the forward contract in commodities, in particular, is a permissible contract since it does not contradict any clear text of the *shari‘ah* and there is a general need for it either by individual businessmen, companies or even by governments. Moreover, it is clear that the rejection of this contract by many contemporary Muslim jurists on the grounds that it contradict the “*ḥadīth*” about *bay‘ al-kāli‘ bi al-kāli‘*, the *ijmā‘* which is believed to have materialized upon this “*ḥadīth*” or the principle “do not sell what is not with you” are all weak arguments as explained.

This is because the *ḥadīth* is unanimously agreed that it is a weak *ḥadīth* and therefore, could not be a genuine evidence. Regarding the *ijmā‘* it is unanimously agreed that not all form of sale of debt for debt are illegal or *ḥarām*, therefore, even if we admit the existence of an *ijmā‘* regarding the prohibition of the sale of debt for debt it would definitely include only some forms of sale of debt for debt and not all. However, there are different opinions about what kind of sale of debt for debt is covered by this *ijmā‘*. And it is the principle in Islamic jurisprudence that whenever specific evidence is doubtful it shall be rejected *al-dalīl idha taṭarraqa‘ ilaihi al-iḥtimāl saqata bihi al-istidlāl*. Therefore, it is submitted that even if we accept the existence of an *ijmā‘* it would be limited only to cases of sale of debt for debt involving *ribā* or excessive *gharar* which are definitely not present in case of the conventional forward contract.

On the other hand, it is submitted that the claim that there is no benefit in such contract is unwarranted. It is an established fact nowadays that the forward contract represents the backbone of contemporary international trade and no country or company can ignore its importance in managing its businesses.

Ironically, many contemporary scholars have admitted the legality of *istiṣnā‘* where both countervalues are deferred, typically as it is the

¹ See Dallah al-Barakah *Hawliyyat al-Barakah*, al-Barakah Investment and Development Company General Secretariat, Unified Shar‘iah Board, issue no. 2, December 2000, p. 290.

² *Ibid.*, p. 274.

case in the conventional forward contract based on *istiḥsān* and need but rejected the conventional forward contract. Perhaps for the simple reason that *istiṣnāʿ* is admitted by the early ḥanafī jurists while the conventional forward contract is not. However, it is submitted that if these contemporary Muslim jurists have opted for the legality of *istiṣnāʿ* based on the ḥanafī's opinion and, putted aside the opinion of the three other schools which regard *istiṣnāʿ* as an illegal contract, due to the need for such an independent contract in contemporary business, they have to accept, similarly, the legality of the conventional forward contract which has the same legal characteristics as *istiṣnāʿ* and which is much needed today than *istiṣnāʿ* itself.

In a similar approach some scholars accepted the permissibility of deferring of the price of *salam* for three days as it is the stand in the Mālikī school or even more than that due to contemporary practical constrain, but rejected the permissibility of deferring the price in the forward contract. It is submitted that if it is permissible to defer the price of *salam* for three days, more or less there is no reason for not applying the same principles with regard to the forward contract.

The main alternative advanced by the opponent for the conventional forward and futures contracts is the *salam* contract. However, it is clearly articulated by a number of honest Muslim economists that *salam* could not solve these problems and there is a genuine need for the forward contract. Therefore, insisting on *salam* as the only alternative to conventional forward contract means putting Muslim businessmen in a disadvantageous position without genuine reason which may encouraging them to invest their wealth in foreign financial institutions for better management and planning even if that will lead sometimes to a clear contradiction with the principles of Islamic law.

Some commentators have proposed the concept of *al-waʿd* (promise) which shall be binding on both parties. However, it is clear that if the promise is binding on both parties, it would be a clear forward contract despite the theoretical differences advanced by the proponent of this argument. Therefore, it is submitted that the conventional forward contract in commodities is a genuinely needed contract. Hence, it is a valid contract because there is no genuine text to prohibit it. Moreover, it is an established principle in Islamic law that prohibition could only be established by means of decisive evidence which is not the case with the forward contract.

Similarly, it is maintained that the forward contract could be based on *bayʿ al-ṣifah* or sale by description especially its concept in the Mālikī's

school where it is possible to defer both countervalues if the subject matter of the contract is well defined.

Despite the fact that the majority of contemporary Muslim scholars are still opposed to the forward contract, the admission of the forward contract into Islamic law is gaining slowly momentum. Thus, we have seen some scholars, who are members of the Islamic Fiqh Academy and regular participants of al-Barakah forum such as Mukhtār al-Salāmī,³ Rafīq al-Masrī,⁴ Hasan al-Jawāhirī⁵ Muhammad ‘Ali al-Taskhīrī,⁶ accepting this contract and rejecting the claim that it is a kind of prohibited sale of debt for debt, the sale of nonexistent, a sale of *gharar* or a sale without benefit.

Meanwhile ‘Abd al-Wahhāb Abū Sulaimān⁷ and Aḥmad ‘Ali ‘Abd Allāh⁸ admitted it by analogy to *bay‘ al-ṣifah* while others such as Nazīh Ḥammād adopted it into Islamic law under the rules of *ḍarūrah* or necessity. Ṣiddīq al-Ḍarīr⁹ on the other hand although he maintained that the forward contract is not governed by the concept of sale of debt for debt and does not involve *gharar*, and it does not involve the sale of nonexistent, yet he abstained from upholding its permissibility for the simple reason that such an opinion will oppose the majority’s stand as it is elaborated earlier.

Regarding trading gold on a forward basis it is maintained that the different approaches taken so far to address the issue are less than convincing. Thus, the present study critically analyzed the opinion that trading gold in exchange of paper money in deferred basis is permissible because paper money are not currencies but a commodities and therefore, there is no case of money exchange or *ṣarf*. Such a stand has

³ Mukhtār al-Salāmī, “Ta’jil al-Badalayn Fi al-‘Uqūd”, *Nadwat al-Barakah al-Tāsi‘ah ‘Asharah lil Iqtiṣād al-Islāmī Makkah al-Mukarrah 7–8 Ramadān 1421H*, December 2–3, 2000.

⁴ Rafīq al-Masrī, *Munāqasāt al-‘Uqūd al-Idāriyyah*, Dār al-Maktabī, Damascus, 1999.

⁵ Hasan al-Jawāhirī ‘*Uqūd al-Tawrīd wa al-Munāqasāt* paper presented to the twelve session of the Islamic Fiqh Academy, Rabat-Morocco. Also see the discussion regarding ‘*Uqūd al-Munāqasāt Majallat Majma‘ al-Fiqh al-Islāmī*, no. 9, vol. 2, pp. 308–309.

⁶ *Majallat Majma‘ al-Fiqh al-Islāmī*, no. 9, vol. 2, pp. 297–306.

⁷ ‘Abd al-Wahhāb Abū Sulaimān, ‘*Aqd al-Tawrīd Dirāsah Fiqhiyyah Tahliliyyah*, paper presented to the twelve session of the Islamic Fiqh Academy, Rabat-Morocco.

⁸ See, Aḥmad ‘Ali ‘Abd Allāh, “al-Bay‘ ala al-Ṣifah” paper presented in *Nadwat Bnak al-Shamāl lita’šil al-‘Amal al-Masrafi*, 20–21 June 1997.

⁹ See, *Majallat Majma al-Fiqh al-Islāmī*, no. 9, vol. 2, pp. 325–333.

no touch with reality because paper money are the real medium of exchange and store of value nowadays and not commodities.

Similarly it is maintained that it is inappropriate to consider paper money like *fulūs* used in Islamic history and which are considered by the majority of scholars as not having the characteristics of gold as a store of value and medium of exchange. It is also submitted that it is inappropriate to ignore the present day reality that gold is no longer the medium of exchange and store of value as it is used to be before. It is inconceivable to admit that the *'illah* or the ratio behind the prohibition of exchanging gold and silver unless they are hand to hand is that they are the medium of exchange or *mutlaq al-thamaniyyah* and to ignore the effect of this *'illah* when it is almost not present, as is the case nowadays, and to insist that gold and silver are currencies by creation without any legal basis. Yet, the present study acknowledges the complexity and sensitivity of the issue and calls for a collective *ijtihād* to resolve this issue. Nevertheless, the concept of promise to sell gold followed by a contract to confirm it during delivery time can be accepted as a temporary solution for gold trading.

On the other hand, arguing for the legality of the forward contract in commodities does not mean any new transaction needed by Muslim traders or businessmen should be admitted even if it contradicts clear text of the Qur'ān or the sunnah. It is based on such an approach that the present study has concluded that in spite of the fact that the forward contract in commodities is legal, such permissibility could not be extended to the forward currency market for reason that this will lead to *ribā* while the *sharī'ah* texts are clear regarding the prohibition of *ribā*.

Considering the fact that a suitable alternative is needed, several proposals have been advanced with the promise to buy or to sell currencies in future as a preferred temporary solution. Some other solutions such as the concept of mutual loan through the setting up of cooperative fund or the basket currencies as means of risk management have also been discussed.

The present study concludes that the development of a viable Islamic future market is possible whether we chose the conventional forward contract or *salam* as the basis for such a market. However, developing a future market based on *salam* requires the resell of the subject matter of *salam* before taking possession or the conclusion of a parallel *salam*. However, the idea of reselling the subject matter of *salam* before taking possession has been rejected by the majority of contemporary Muslim

jurists for the simple reason that the majority of early Muslim jurists has done so.

Here, we are faced once again with a methodology which does not give any due consideration to *al-ijtihād al-intiqā'ī*¹⁰ and fails to benefit from the opinion of Ibn Taymiyyah and his disciple Ibn Qayyim who very successfully expounded that there is nothing in the texts or Qiyās which prohibits the resell of *salam* before taking possession or the Mālikī's opinion that such a transaction is legal if the subject matter of contract is not foodstuff.

Moreover, considering the fact that the main argument against sale prior to taking possession in the work of classical Muslim jurists, is the possibility of *gharar*, the present study argued that such a *gharar* is almost nonexistent in the contemporary futures market with the presence of the clearing house which guarantees the execution of the contract. This is furthermore enhanced by the tight supervision of the market by the exchange authorities by controlling the position of the market participants and the fidelity fund which is established in order to compensate the victim of a default by brokers. Thus, it is concluded that it is permissible to sale before taking possession, in reliance on the opinion of the Mālikī school and that of Ibn Taymiyyah and Ibn Qayyim and the absence of *gharar*.

Regarding speculation it is submitted that despite the fact the issue is most commonly cited to invalidate derivatives contract, it is almost impossible to get rid of speculation in its broader sense because every business requires a degree of speculation and forecast. It is based on this reality that several Muslim economists such as Fahīm Khān, Aḥmad 'Abdel Fattāh, Muhammad Akram Khān, Muhammad Obaitullah and others acknowledge that a limited form of speculation is not only unavoidable but desirable to the good performance of the market. Yet, excessive speculation based on manipulation, cornering and fraud is unIslamic and any possible use of derivatives contracts in Islamic finance must be clear of that kind of speculation.

Furthermore, it has been demonstrated that associating speculation with financial crisis is not always justified. Yet, speculation definitely aggravates the situation but generally the real causes of the problem lies elsewhere. It could weaknesses in the macro and microeconomic

¹⁰ Regarding the concept of *al-ijtihād al-intiqā'ī* see, Youssuf al-Qaraḍāwī, *al-ijtihād fi al-Shar'iah al-Islāmiyyah*, Dār al-Qalam, 1989, Kuwait.

structure of the economies affected as it is the case with the financial crisis of 1997 in South East Asia or due to poor supervision and lack of decisive management of the specific affected market as it is with the crash of the Futures Commodity Market in Malaysia 1984 or the crash of the stock market crash in Kuwait 1984.

The study on options from an Islamic perspective shows that *khiyār al-sharṭ* could serve as a tool of risk management and fulfill some of the benefits associated with conventional options. It could be used in *murābahah*, *ijārah*, and ordinary sale or common stocks trading as a tool of risk management as it has been explained above. Moreover, if we consider the possibility of charging a fee in exchange of giving an option, the benefits of *khiyār al-sharṭ* as a tool of risk management may be parallel to that of the conventional options at least in the primary market. Yet, from the above investigation, there is nothing in Islamic law, which prevents the exchange of such a right for money.

Moreover, the present study reveals that the possibility of Islamically acceptable options through *bay' al-'arbūn* is much promising than it is with *khiyār al-sharṭ*. Thus, *arbūn* as a tool of risk management could be used in commodities and services, share trading, in *murābahah*, *salam* and *istiṣnā'*. Designing a call option through *'arbūn* is already acknowledged by some Muslim economists while the possibility of a put option is also possible through the reverse *'arbūn* as it is defended throughout the present study or through other formulas mentioned above.

Furthermore, the expansion of options trading requires that the right in options must be accepted as a valid subject matter of a contract. Some previous studies have concluded that such a pure right could not be a valid subject matter of contract in Islamic law and therefore, option trading is illegal. This conclusion has been refuted in the present study. First of all, the concept of *māl* or property in Islamic law does include rights according to the majority of Muslim scholars. And since the right in options trading is a property right, it is considered as *māl* and therefore, it could be the subject matter of contract. Secondly, given the fact that there is no single text, which defines the characteristics of a right which should be accepted as a property right, the whole issue is based on custom. Considering the fact that the right in options trading is recognized internationally as a property right, it can be regarded as a valid subject matter of a contract in Islamic law since this does contradict any text.

Moreover, the treatment of numerous cases involving the sale or exchange of rights shows that the right in options trading should not

be an exception, given the fact that there is no text which stipulates certain rights could be exchanged while others could not.

To support this proposition, the present study referred to several cases where a right is sold or exchanged with money, such as, the case of *ḥaqq al-nuzūl ‘an al-wazā‘if*, the right of *shuf‘ah* or preemption, the rights of *irtifāq* or *ḥuquq al-irtifāq*, the right in *badal al-khulu*, the right of precedence over unused land, the right in intellectual property, the right of option in *khiyār al-sharṭ* exchanging one’s right to bargain with something, a wife exchanging her right to have her husband with her, in her journey, dropping her right of *ḥadānah* or custody in exchange of something, or dropping one’s right to recover one’s gift in exchange of something. All these cases show that any property right or *ḥaqq māli* could be sold or exchanged if the prevailing custom allows it. Therefore, the right in options trading could be exchanged by analogy to the above cases and based on the general theory of freedom of contracts and conditions.

Besides, the present study concluded that the claim that options trading involves the combination of two contracts in one transaction is unwarranted. None of the interpretations given to the *ḥadīth* about this kind of sales falls within the purview of options trading. In addition, it is demonstrated that the claim that options trading is a kind of gambling is unfounded.

However, since the derivatives instruments discussed above are just the fundamental forms of derivatives available in the international market and considering the fact that it is possible to create an infinite variety form of derivatives instruments¹¹ the present study will attempt to advance some of the Islamic contracts with derivatives potential for future consideration.

The contract of *istijrār* for instance, offers a great potential for risk management. It is a contract which differs from the ordinary sale by virtue of the fact the price in *istijrār* may not be exactly known at the time of conclusion of the contract, as it is in ordinary sale, but determined according to market price. In other words, it is a contact of buying a specific commodity in a regular basis, according to market price, with the price settled at the end of the deal or has been placed as a deposit with the seller. The exact price of the commodity could be known during

¹¹ See Iqbāl Afzal “Engineering Islamic Finance”, *Islamic Banker*, November 1996, p. 241.

the period of *istijrār* if the price of the commodity is stable. It could be also a flouting price such as the market price in specific day if it is well defined and could not lead to dispute. The contract is not widely applied. However, according to Obaidullah cases of *istijrār* are introduced by the Muslim Bank of Pakistan and by Dār al-Māl al-Islāmī group.¹²

According to the *istijrār* contract the sale price of the commodity that is traded, is computed as the average of the market prices during the financing period. To illustrate the situation let us take the following example. A firm needs a short term financing for its raw material purchases for a specific period, say six months. The firm approaches an Islamic bank to finance this purchase. The sale price is not set at the conclusion of the contract but rather it is determined at the end of the financing period. The sale price is set at the average of series prices of the material during the period of financing. *Istijrār* can include an option or *khiyār al-sharṭ* for either party to the contract.

On the other hand, innovations in derivative trading in the conventional system is growing fast. One of the recent innovations is swaps contracts. There are interest rate swap, currency swap, equity swap and commodity swap. Definitely interest rate and currency swaps are out of Islamic finance due to the clear involvement of *ribā* as it is the case with interest rate swaps or the deferred delivery in currency swap which also a kind of *ribā*.

However, some Muslim economists propose commodity swaps, as an instrument that could be accommodated into Islamic finance. It is maintained that commodity swaps are more naturally fit into Islamic financial system which promote trade. This is justified on the basis that swap agreement is simply a series of forward contract and the legality of forward is already established.

Commodity swaps are used by many consumers and producers of commodities to hedge price rises over a long term period. Consumers and producers are often linked to long terms contracts to buy or sell where the delivery price is determined by price index price. This means that the price at delivery is not known until a short time beforehand or until the actual delivery date.¹³

¹² Obaidullah, "Financial Engineering with Islamic Options", *Islamic Economic Studies*, p. 93.

¹³ The Reuters Financial Training Series, *An Introduction to Derivatives*, p. 136.

Energy swaps for oil products, in particular, has been increasingly more important in the derivatives markets since 1991.¹⁴ Thus, it is suggested that “for countries whose economies are heavily dependent on the sale or purchase of a commodity such as oil producing Muslims countries of the Persian Gulf, commodity swap can offer price protection against futures price variations and can provide better control and forecasting in the futures”.¹⁵

Despite the fact the proponents of commodity swap maintain that it is a series of forward contracts, one of the fundamental differences between the two contracts is that in the forward contract there is clear commitment of taking delivery while in the commodity swap there is no possibility of any physical transfer. This issue may stand as a stumbling block in the admission of this new type of derivatives instrument into Islamic finance.

¹⁴ Ibid.

¹⁵ Zamir Iqbal, “Financial Innovation in Islamic Banking”, p. 14.

GLOSSARY OF ARABIC TERMS

‘ <i>Adl</i>	Justice, fairness, balance.
<i>Aḥādīth</i>	Plural of <i>ḥadīth</i> . (For meaning, see below.)
<i>Aḥkāṃ</i>	Plural of <i>ḥukm</i> . (For meaning, see below.)
<i>Al-ghurm bi al ghunm</i>	One is entitled to a gain only if one agrees to bear the responsibility for the loss.
<i>Al-kharāj bi al-ḍamān</i>	Entitlement to return or yield is for the one who bears the liability (<i>ḍamān</i>) for something.
‘ <i>Aqīdah</i>	Belief and creed.
<i>Athmān</i>	Pls. of <i>thaman</i> , money of exchange.
<i>Awqāf</i>	Plural of <i>waqf</i> . (For meaning, see below.)
<i>Āyah</i>	A verse from the <i>Qur’ān</i> .
<i>Bay’</i>	Sale contract.
<i>Bay’ al-‘arbūn</i>	A sale contract, in which a down payment is given and the parties commit themselves to the agreed conditions. The buyer has the right to cancel the sale, but then he will lose the Down payment.
<i>Bay’ al-a‘ayān</i>	Sale of tangible objects such as goods (as against Sale of services or rights).
<i>Bay’ al-dayn</i>	Sale of debt.
<i>Bay’ al-dayn bi al-dayn</i>	A sale contract involving exchange of one debt with another.
<i>Bay’ al-ma‘dūm</i>	Sale of a commodity which does not exist.
<i>Bay’ al-‘īnah</i>	Selling of something to someone at a given price (usually on credit) and then buying it back from him at the same time at a different price (usually for a lower price, but cash).
<i>Bay’ al-kālī’ bi al-kālī’</i>	A sale in which both the delivery of the object of sale and the payment of its price are delayed. It is similar to a modern forward Sale contract.
<i>Bay’ al-salam</i>	It is also called <i>bay’ al-salaf</i> . A sale contract where two parties agree to carry out a sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid on spot.

<i>Bay' al-ṣifah</i>	Sale based on detailed description of the object of sale.
<i>Bay' bi-thaman al-'ājil</i>	Another term used for <i>bay' mu'ajjal</i> . For meaning see below.
<i>Bay' mu'ajjal</i>	Sale on credit or a sale in which goods are delivered immediately but payment is deferred.
<i>Buyū'</i>	Plural of <i>bay'</i> : Sales.
<i>Ḍarar</i>	Damage, harm, injury.
<i>Dayn</i>	Debt.
<i>Ḍarūrah</i>	Necessity. (Usually used whereby something otherwise prohibited becomes temporarily permissible.)
<i>Dhimmah</i>	Liability, responsibility.
<i>Dinār</i> (plural <i>Danānīr</i>)	A monetary unit. In early Islamic history.
<i>Dirham</i> (plural <i>Darāhim</i>)	A monetary unit. In early Islamic history.
<i>Fāsīd</i>	Irregular. It refers to irregularities in, or non-fulfilment of, some conditions of the contract. The contract is null and void in majority opinion but not the Hanafi school.
<i>Fatāwā</i>	Plural of <i>fatwā</i> . Religious verdicts by Muslim Scholars.
<i>Fiqh</i>	Refers to the whole body of Islamic jurisprudence. It covers all aspects of life, religious, political, social, commercial or economic. It is based primarily on interpretations of the <i>Qur'ān</i> and the <i>Sunnah</i> . While the <i>Qur'ān</i> and the <i>Sunnah</i> are immutable, <i>fiqh</i> verdicts may change due to changing circumstances.
<i>Fulūs</i>	cheap metal or copper money.
<i>Fuqahā'</i>	<i>sharī'ah</i> Scholars.
<i>Gharar</i>	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the

	buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal, thus exposing either of the two parties to unnecessary risks.
<i>Gharar fāhish</i>	Excessive gharar.
<i>Gharar Yasīr</i>	A little bit of <i>gharar</i> . It is tolerable because it may be unavoidable
<i>Hadānah</i>	The right of custody of a child after divorce.
<i>Hadīth</i>	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
<i>Ḥajj</i>	Pilgrimage to Makkah. It is an obligatory duty on every Muslim if he can afford it, physically and financially.
<i>Halāl</i>	Things or activities permitted by the <i>sharī'ah</i> .
<i>Ḥanafī</i>	A school of Islamic jurisprudence named after Imam Abu Hanifa.
<i>Ḥanbali</i>	A school of Islamic jurisprudence named after Imam Ahmed bin Ḥanbal.
<i>Ḥaqq</i>	Right.
<i>Ḥaqq al-irtifāq</i>	Literally, the right of utilization or easement; technically, the right to derive benefits gratis from the immovable property of someone else. The right has been recognized by the <i>sharī'ah</i> in the spirit of generosity that members of a community should display towards each other.
<i>Ḥaqq al-nuzūl an al-wazā'if</i>	Under Islamic law, certain appointments are for the lifetime of the incumbent. However, he can relinquish the post by his own volition. <i>Ḥaqq al-nuzūl an al-wazā'if</i> refers to this right of relinquishing the post. According to some scholars, he can relinquish his post to another person in exchange for money. Other scholars do not allow charging any money.

<i>Ḥarām</i>	Things or activities prohibited by the <i>sharī'ah</i> .
<i>Ḥaraj</i>	Difficulty and hardship.
<i>Ḥīlah</i> (plural <i>ḥiyal</i>)	Legal trick or device to avoid imposition of a law in a particular case.
<i>Ḥuqūq al-irtifāq</i> (singular <i>ḥaqq al-irtifāq</i>)	Refers to certain rights granted (gratis) to a neighboring house owner, such as, to place a beam on his wall, pass a sewage pipe through his territory to connect to the main line, etc.
‘ <i>Tbādāt</i>	Duties of man due to God.
’ <i>Tbāḥah</i>	Permissibility from a <i>sharī'ah</i> point of view.
<i>Ijārah</i>	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
<i>Ijārah muntahiyyah bil-tamlīk</i>	Lease ending in ownership.
<i>Ijmā‘</i>	Consensus of Muslim scholars in specific issue. <i>Ijma‘</i> is one of the source of Islamic law.
<i>Ijtihād</i>	Endeavour of a jurist to derive a rule or reach a judgment based on evidence found in the Islamic sources of law, predominantly, the <i>Qur‘ān</i> and the <i>Sunnah</i> . The intellectual effort of Muslim jurists to reach independent religio-legal decisions.
‘ <i>Illah</i>	Effective cause, ratio legis or Reason/characteristic behind a <i>Sharī'ah</i> ruling such that if a particular reason/characteristic is found in other instances, the same ruling will apply.
<i>Istihsān</i>	It refers to departure from a ruling in a particular situation in favour of another ruling, which brings about ease. This is done by taking a lenient view of an act

- which would be considered a 'violation' on a stricter interpretation of the action based on earlier *qiyās*.
- Istijrār* It is a contract of buying a specific commodity in a regular basis, according to market price, with the price settled at the end of the deal and kwon during the period of the contract.
- Istisnā'* A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good at a given price on a given date in the future.
- Ju'ālah* A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
- Karāhiyyah (makrūh)* Something that is not completely prohibited by the *sharī'ah* but is abhorred.
- Kayliyyan* Weighable.
- Khiyār* Option.
- Khiyār al-'ayb* Option to rescind a sales contract if a defect is discovered in the object of sale.
- Khiyār al-Shart* The option to rescind a sales contract based on some conditions. One of the parties to a sales contract may stipulate certain conditions which, if not met, would grant a right to the stipulating party to rescind the contract.
- Khiyār al-Naqd* It is the right of either of the parties to confirm the contract or to cancel it by means of the payment of the price. In other words, it is the conclusion of a contract with the option that the payment of the price, within a specific period, would confirm the contract while a failure to do so would get cancelled.
- Khulu'* Divorce in return for forgoing dower of wife or the giving of monetary compensation by the wife to the husband.

<i>Mdhab</i> (plural <i>madhāhib</i>)	School of Islamic law.
<i>Mafṣadah</i> (plural <i>Mafāsīd</i>)	Anything declared harmful by the <i>sharī'ah</i> or anything hampering the achievement of the <i>maqāsīd</i> of <i>sharī'ah</i> .
<i>Māl</i>	Asset, property.
<i>Māliki</i>	A school of Islamic jurisprudence named after Imam Malik.
<i>Manfa'ah</i>	Usufruct. Benefit derived from a durable commodity/asset.
<i>Maqāsīd al-Sharī'ah</i>	Basic objectives of the <i>sharī'ah</i> . These are protection of faith, life, progeny, property and reason.
<i>Masālih Mursalah</i>	Sing. <i>Maslahah</i> Public interest as determined in the light of the rules of <i>sharī'ah</i> . A <i>Maslahah</i> refers to any action taken to protect any one of the five basic objectives of the <i>sharī'ah</i> .
<i>Maysir</i>	Technically, gambling or any game of chance.
<i>Mu'amalāt</i>	The corpus of Islamic law regulating relation and contracts among human beings (as against <i>Ibādāt</i> , which define relationship between God and His creatures).
<i>Mu'awadāt</i>	Contracts which involve exchange of value for value. As against this, <i>tabarru'āt</i> are contracts involving one-way transfer of value.
<i>Mudarābah</i>	A contract between two parties, capital owner(s) or financiers (called <i>rabb al-māl</i>) and an investment manager (called <i>mudārib</i>). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
<i>Mudārib</i>	An investment manager in a <i>Mudarabah</i> contract.

<i>Muhtasib</i>	Government Officer supervising the market.
<i>Mukhātarah</i>	Risk.
<i>Muqāraḍah</i> or <i>Qirāḍ</i>	Carries the same meaning, as <i>Mudārabah</i> For meaning, see above.
<i>Muqāwalah</i>	
<i>Murābahah</i>	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer.
<i>Mushārahah</i>	Partnership. A <i>mushārahah</i> contract is similar to a <i>mudārabah</i> contract, the difference being that in the former both partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
<i>Najash</i>	To bid up the price of the item, not with the intention to purchase the item, but rather to raise the price for the customers intending to deceive the buyers).
<i>Naṣ</i>	Text from <i>Qur'an</i> or <i>Sunnah</i> .
<i>Qabḍ</i>	Possession.
<i>Qāḍi</i>	Judge.
<i>Qimār</i>	Gambling.
<i>Qiyās</i>	Application of a rule/law on the analogy of another rule/law if the basis (<i>'illah</i>) of the two is the same. It is one of the secondary sources of Islamic law.
<i>Rabb al māl</i>	Capital owner (financier) in a <i>Mudārabah</i> contract.
<i>Rahn</i>	To pledge something of material value as a security for a debt or pecuniary obligation.

<i>Ribā</i>	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is a form of <i>riba</i> .
<i>Riba al-Fadl</i>	<i>Riba</i> pertaining to trade contracts. It refers to exchange of different quantities (but different qualities) of the same commodity. Such exchange in particular commodities defined in the <i>sharī'ah</i> is not allowed.
<i>Riba al-nasīā'</i>	<i>Riba</i> pertaining to loan contracts.
<i>Rihān</i>	Betting.
<i>Salam</i>	The short form of <i>bay' al-salam</i> .
<i>Samāsirah</i>	Brokers.
<i>Sarf</i>	Currency exchange.
<i>Shāfi</i>	A school of Islamic Law named after Iman Shafii.
<i>Sharī'ah</i>	Refers to the corpus of Islamic law based on Divine guidance as given by the Qurān and the Sunnah and embodies all aspects of Islamic faith.
<i>Shuf'ah</i>	Right of pre-emption.
<i>Sunnah</i>	The <i>Sunnah</i> is the second most important source of the Islamic faith after the <i>Qur'ān</i> and refers to the Prophet' (peace be upon him) example as indicated by his practice of the faith. The <i>sunnaḥ</i> is the collection of <i>ahādith</i> which consist of reports about the sayings, deeds and endorsements of the Prophet (peace be upon him).
<i>Ta'ām</i>	Eatables.
<i>Ta'āwun</i>	Cooperation (for good).
<i>Tabarru'</i>	Actions/contracts, the purpose of which is not commercial but is seeking the pleasure of Allah.
<i>Tahjīr</i>	Barren land.
<i>Takāful</i>	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone member of the group, the loss is met from the collected funds.
<i>Thaman</i>	Money.
<i>'Urf</i>	Custom.
<i>'Uṣūl</i>	Principles, basics.

<i>'Uṣūl al-fiqh</i>	Islamic Jurisprudence.
<i>'Ulūm al-ḥadīth</i>	Science of the ḥadīth.
<i>Wakālah</i>	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
<i>Waqf</i>	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the <i>waqf</i> .
<i>Zakāh</i>	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a particular level of wealth.
<i>Zanni</i>	Based on conjecture.

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INDEX

- Abd Allah bin Beya xv
 Abd al-Wahhab Abu Sulaiman 38, 66,
 270, 287, 302
 Abu Ghuddah 20, 167, 288
 Ajeel Jasem xiv
Al-ghurm bi al ghum 309
 Ahmad Ali Abdullah 58
Al-kharāj bi al-ḍamān 309
 Ali al-Salus 84 n. 29, 161
 Al-Taskhiri 38, 213, 302
 Al-Zuhaili 19, 166–167, 172–173, 239
 American option 203–204, 257
 Arbitrage 30, 44, 137, 155–156
Athmān 5, 84, 86–90, 101, 309
- Bay' al-'arbūn* 7–8, 10, 35–36, 38–39,
 42, 204, 220, 238–240, 251, 305, 309
Bay' al-a'ayan 309
Bay' al-dayn bi al-dayn 10, 26, 63, 118,
 171–172, 174–175, 309
Bay' al-'inah 147–148, 163, 265, 309
bay' al-kāli' bi al-kāli' 5, 9, 12, 17–18,
 20–21, 27, 32, 49, 53, 57, 59, 64, 80,
 106, 108, 129, 171–175, 299–300, 309
Bay' al-ma'dūm 270, 309
Bay' mu'ajjal 23, 263
Bay' al-salam 17, 23–24, 48–50, 63, 99,
 209, 309
Bay' al-ṣifah 12, 48–49, 65–67, 70,
 301–302, 310
 Bazie Al-Yaseen xiii
 Bretton Woods system Brokers 74
 Bucketing 186
- Call option 11, 39, 196–197, 204–205,
 220, 243, 246, 253–254, 263–264, 305
 Cash market 30, 121, 168
 Chicago Board 130, 206, 208
 Clearing house 125, 132, 137,
 139–140, 168, 171, 173, 182–183, 304
 Combination of two contracts in one
 transaction 41, 221, 251, 264, 306
 Commodities 4–5, 8, 10–11, 13–16,
 19, 22, 26, 28, 37, 44, 49, 51, 58,
 61, 70–73, 76–78, 80, 82, 84–85, 89,
 91–92, 95, 97–98, 111, 118, 122–126,
 128, 130–133, 135–136, 138–142, 146,
 149–151, 160, 162–164, 168, 170–171,
 181–182, 207–208, 210, 214–215, 220,
 243, 260, 289, 299–303, 305, 307
 Contract 2–3, 5–30, 32–53, 55–72, 76,
 79–82, 85, 93, 95–100, 103–106, 108,
 113, 115–118, 121–131, 133–136,
 139–141, 143, 146–148, 153–154,
 157–159, 165–171, 173–182,
 186–187, 189–191, 195–196, 198–204,
 206–215, 218–232, 234–235, 237,
 240–259, 261–262, 264, 266–272, 277,
 287–288, 291–292, 294, 298–299–310,
 313–317
 Cooperative fund 11, 303
 Countervalues 9, 11, 19, 30, 33, 42, 46,
 48, 52–54, 58–60, 63–65, 76, 80, 97,
 99–100, 102, 108, 123, 147, 171–172,
 175, 226, 259, 300
 Currency
 currency by creation 91–93
 currency exchange 6, 12–13, 19, 24,
 29, 57–60, 96–97, 100, 102–103,
 105–108, 114–115, 170, 209, 242,
 316
 Currency basket 110
 Custody 10, 272, 296–297, 306, 311
 Custom 21, 32, 45, 59–60, 77, 79–80,
 86–87, 93, 105, 110, 114–115,
 169–170, 178–180, 188–189, 229,
 239, 266, 273–277, 281–282, 284–286,
 292–293, 298, 305–306, 316
- Daily
 marking 34, 117
 price 127, 190
 turnover 153
 volume 153
 movement 190
 limit 190
Ḍarūrah 18, 115–116, 302
 Debt/s 5–6, 8–9, 12, 21 n. 13, 26,
 32–33, 51, 54, 57–59, 63, 67, 70,
 90–91, 94, 97, 107, 109, 118, 121,
 157, 172–176, 179, 185, 218, 300, 302,
 309–310, 315

- Deferred
- basis* 5–6, 12, 71, 77–80, 82–87, 89–90, 93, 95, 98, 101, 228, 265, 302
 - commodity* 28, 50, 250
 - contract* 15, 97, 103
 - debt* 175
 - delivery* 50, 307
 - payment* 86, 106
 - sale* 23, 27, 63, 69
 - settlement* 100
 - trading* 209–210
- Derivatives
- contracts* 23, 299, 304
 - instruments* 4, 9, 218–219, 299, 306, 308
 - market* 3–4, 121, 144, 206, 308
 - trading* 9, 11, 19, 71, 137–138
- Difference of Opinion 20, 30, 159, 172, 189, 219, 226, 247, 256, 278, 283, 287, 289, 295–296
- Dinār* 79–80, 88, 93, 101, 107, 173–175, 237, 264–265, 294, 310
- Dirham* 79, 93, 101, 104, 173, 175, 237–238, 265, 268, 310
- Divorce 295–297, 311, 313
- Dubai Islamic Bank 75–76, 248, 249 n. 35
- Economics 6, 10, 12–13, 15, 25, 26
n. 19, 28, 36, 47, 59–60, 72, 76, 79, 90, 103, 121, 130, 135, 137–138, 145–147, 149, 151–154, 156, 183–184, 198–199, 210, 215, 217–219, 229–230, 255, 261, 266, 310
- El-Gari 17–18, 35–36, 90, 92, 109, 157, 198–199, 208, 253, 256–257, 271
- European option 12, 203–204
- Exercise
- date* 204
 - price* 203–204, 229
- Fahim Khan 28–30, 51, 134, 144–145, 167–168, 304
- Financial
- crisis instruments 12, 109, 150, 304–305
 - institution xx, 1, 3–5, 37, 83, 301
 - market transaction, right 15
 - system, value 6, 10, 49, 118, 154, 198, 225, 231, 247, 261, 307
- floor 121, 132, 140, 151, 191
- Fluctuation 11, 15, 31, 38, 44, 63, 96, 102–103, 106–107, 109–112, 135–136, 138, 142–143, 199, 229, 263
- Foodstuffs 123, 130, 133, 148, 159–165, 184, 224, 304
- Foreign currency 19, 29, 96, 99, 103, 104–106, 108, 113–114
- Forward
- basis* 5–6, 9, 11–12, 72, 82, 93, 224, 302
 - contract* 5–8, 11–12, 18–19, 23, 25–27, 34, 44–51, 55, 57, 60–67, 70–71, 97, 105, 113, 115–118, 122, 124–125, 128–130, 134, 165, 170, 175, 195, 299–303, 307–308
 - currency exchange market 12, 24, 96, 103
 - price 116
 - sale, trading 12, 42, 55, 63, 259, 309
- Freedom of contract 40, 210, 220, 231, 252, 256, 259, 267, 269, 306
- Fulūs* 79, 84, 86–87, 94, 96, 98–100, 209–210, 224, 303
- Fungible good 26, 33, 68
- Futures Contract 6, 8, 10, 12, 14–18, 20–23, 25–26, 28–30, 34, 48, 50, 116–118, 121–126, 129–131, 133–136, 140, 143, 147–148, 159, 168–171, 175, 178–179, 181–182, 186–187, 191, 195, 201–202, 208, 211, 218, 301
- Futures Industry Act 8–9, 12, 118, 121–122, 139, 177–180, 182, 186–187, 189
- futures Brokers 8, 177, 180
- futures fund manager 177–178
- contract commodity 18, 130, 158
- exchanges 117, 139, 190
- industry: market 8, 10–12, 15, 25, 28–30, 32, 37, 42, 49, 117–118, 121–125, 128, 130–135, 138–142, 144–145, 148, 150, 153, 157, 162–165, 167–168, 170, 173, 176, 178, 180–182, 186–187, 191, 201, 304
- trading 5, 8–9, 12, 14–19, 21–22, 24–32, 34, 46, 50, 56, 123–124, 130, 132, 136, 155, 157, 167, 170, 178, 188
- Gambling 4, 7–8, 13–14, 19, 29, 32, 36–38, 42, 55, 118, 143–144, 147, 208, 210–216, 218, 221, 244, 259–260, 306

- Gharar* 17, 26–27, 32, 48, 51 n. 23,
52–56, 58–59, 63–66, 68–70, 108,
160–161, 166, 173, 176, 210, 216, 218,
237, 240, 259, 264, 267, 295, 299–300,
302, 304
gharar fāhish 35, 311
gharar yasīr 311
Gold for gold 72, 76–78, 97, 104–105
gold standard 74
Great Depression 74
- Hadānah* 10, 295, 297, 306, 311
Haqq 272, 296
Haqq al-irtifāq 312
Haqq al-nuzūl an al-wazā'if 276–277,
292, 306
- Ibn Mani 93, 240, 245–246
Ijārah 7, 13, 48, 213, 228, 230,
242–244, 257, 305, 312
Ijārah muntahiyah bil-tamlīk 312
ʿIllah 5, 12, 17, 21, 69, 72, 77, 79–81,
83–87, 89, 94, 98, 100–102, 134, 148,
162–163, 173, 209, 303, 312, 315
illah qāsirah 84
Istisnāʿ 5, 11, 13, 18–19, 23, 25, 28,
48–49, 61–64, 70, 130, 251–252,
299–301, 305, 313
Interest rate 1, 10, 47, 122, 133, 158,
208, 259–263, 299, 307
Islamic law xix, 4–13, 18, 20, 22–23,
25–26, 28–29, 32–33, 37, 39, 43, 45,
47–49, 51–52, 55, 66–67, 70, 72, 86,
89, 94, 103, 106, 113, 115, 118, 129,
159, 180, 188, 201, 218–219, 221–223,
226, 231–233, 237, 244, 251, 256,
258, 263, 266, 269–270, 272–273,
276–277, 280–281, 284, 286, 289–290,
295–296, 299, 301–302, 305, 311–312,
314–316
- Kamali xi, 24–28, 34 n. 39, 38–40,
54, 144, 164, 166, 222, 231, 233, 253,
266–267, 269
Khiyār al-ʿayb 313
Khiyār al-Shart 6–8, 10, 13, 35–36,
38–42, 59, 204, 212, 215–216,
219–220, 222–226, 228–235, 240,
259, 270–271, 273, 287–294,
297–298, 305–307, 313
Khiyār al-Naqd 6–7, 219–220,
222–223, 233–236, 313
Kuala Lumpur Commodity Exchange
23, 117, 131–132, 138, 150
Kuala Lumpur Futures Market 132
Kuala Lumpur Interbank Offered rates
133
Kuala Lumpur Commodities Clearing
House Sdn Bhd 140
Kuwait Finance House 80–81, 106, 161
- Māl* 273, 314
Manfaʿah 36, 213, 273–275, 280–281,
284, 296, 314
Market
 crash 143, 150, 154, 305
 forces 15, 75, 267
 manipulation 151
 movement 150, 196
 participants 15, 118, 123, 138, 170,
 187, 207, 298, 304
 place 29, 124–126, 139, 185
 price 42, 96, 125, 135, 168, 190–191,
 202, 253, 258, 263, 296, 306–307,
 313
 problem 146
 offenses 118
 operation 186–187
 rigging 145
 risk 1, 121
 share 22
 medium of exchange 76–77, 79–83,
 85–95, 98–100, 102, 209, 303
 Mohammed Obaidullah 40, 99–102,
 134, 200, 209, 222, 307
 Monetary system 12, 72–73
 Money by creation 6, 88, 93
 Monzer Kahf xvi
 Muhammad Akram Khan 23–25, 114,
 117, 149, 156, 304
 Mukhtar al-Salami 19, 36–38, 46, 48,
 59, 65, 135, 161, 212–213, 269–270,
 287, 302
 mutlaq al-thamaniyyah 81, 85–87, 94,
 303
 Mutual loan 109–110, 303
 Mutual promise for currency
 exchange 103
- Najash* 32, 184, 189, 315
Nazih Hammad 56, 58, 115, 161,
166–167, 174, 251
- Obaiyathullah 216
Option 6–13, 17–21, 24–26, 32, 34–43,
59, 65, 100–101, 104, 118 n. 50,
121–122, 127, 133, 140, 143, 145,
177–178, 181–182, 191, 196–216,

- 218–234, 237, 241, 243, 246–248,
251–255, 257–267, 269–273, 275,
277–279, 282, 284, 287–294, 297–299,
305–307, 313
- Palm oil 4, 37, 103, 117, 125–127,
131–132, 136–138, 153, 167, 190
- Paper money 12, 76, 78–88, 90, 92–96,
98–100, 102, 209, 224, 302–303
- Permissibility 8–9, 11–12, 24, 27, 40,
51, 55, 57–58, 67, 71, 87, 99–100,
104–105, 134, 165, 174, 239, 269, 277,
297–298, 301–303, 312
- Prevailing 32, 44, 59, 75, 77, 82–83,
104, 134, 161, 170, 245, 251, 262, 266,
270, 276–277, 280–281, 283, 292, 298,
306
- Prohibition 1, 10–12, 17, 21, 23, 27–28,
30, 33, 51 n. 23, 52–53, 58, 64, 68–69,
72, 77, 84–85, 87, 89, 100–101, 106,
109, 129, 133, 148, 160–163, 172–176,
187, 209–210, 239, 256, 264, 272,
300–301, 303
- promise 19, 24, 35, 44, 70, 75, 82, 93,
103–109, 112–113, 229, 238, 245, 247,
249, 283, 299, 301, 303
- Public interest 14, 19–20, 26, 37, 46,
56, 108, 190, 266, 282, 286, 314
- Put option 11–13, 197, 199, 201–202,
204–206, 220, 254, 256–258, 263–264,
305
- Rafiq al-Misri 109
- Risk
management 3–7, 12–13, 33, 37, 40,
93, 116, 121, 132, 142, 191, 204,
219–220, 223, 228–231, 234–235,
252, 275, 299, 303, 305–306
mechanism 124
reduction 39, 252–253
shifting 29, 135–136
- ṣarf* 6, 19, 58–60, 78, 81, 89–90, 96,
103 n. 17, 104–105, 115, 316
- Sale
of commodities 160, 243
of currency by description 5, 48,
65–66, 301
of debt of nonexistent 5, 302
of foodstuff 162–163, 224
of gold 104
of pure right 7–8, 13, 247, 269, 284
prior to taking possession 8, 10, 12,
21 n. 13, 26, 118, 159, 161–163, 304
- Saleh al-Marzuqi 87–89
- Sayyid Abdul Jabbar 23, 117
- Second World War 74
- Securities Commission 182–183,
267–268
- Siddiq Al-Darir 37, 59, 212–215, 241,
255–256, 270, 287, 292, 302
- Silver 5–6, 72–74, 76–81, 83–90,
92–102, 104–105, 209, 303
- Speculation 6, 8, 10, 12, 26, 29–32,
41, 44, 99, 103 n. 17, 118, 131, 141,
143–151, 153–157, 176, 191, 211–212,
216, 229–230, 259–260, 304
- Stock
Exchange 147, 156, 198, 216, 253,
257
indices 16, 19, 29, 208, 214, 259–260,
299
margin 157
market 17, 19, 97, 115, 154, 157,
198–199, 210, 229, 245, 305
option 122
price 205–206
trading 7, 13, 157, 214
- Sudin Haron 49
- Ta'ām* 161, 164–165, 316
- Tahjir* 10, 282, 316
- Taqi Usmani 20, 212, 285–286, 297
- Thaman
thamaniyyah 82, 85–86, 88–90, 93,
95, 98
mutlaq al-thamaniyyah 25, 81,
84 n. 29, 85–87, 94, 303
qhalabat al-thamaniyyah 85
thaman haqiqi 99, 101
- Umar Charpa 25
- United States 74, 78, 91, 124, 130, 206
- Vogel, Frank E. 32, 34 n. 39, 42–43,
168, 254, 257, 272
- weighable 77–78, 85, 101–102, 313
- Zakah* 79–81, 84, 86, 95, 146, 149, 164,
317
- Zamir Iqbal 50

ABSTRACT

The importance of derivative instruments as tools of risk management is taken for granted in the modern financial system. Many Muslim scholars have stressed the need for a prudent utilisation of such instruments in Islamic equity markets, banking and finance. However, these instruments may not be totally in compliance with Islamic principles of *mu'āmalāt*. This study begins with a critical review of the previous works and proceeds to analyse the forward, futures and option contracts from an Islamic point of view. The present study also highlights their economic benefits, their reason d'être, the legal aspect of these contracts which may or may not be acceptable from *sharī'ah* perspective and then attempt is made to propose Islamic alternatives whenever they are deemed necessary and appropriate. Derivatives are used in commodities, shares, currencies, interest bearing transactions and stock indices. The scope of the present analysis is, however, limited to derivative transactions based on commodities and shares. The use of these instruments in interest rate and currencies is out of the scope of the present study due to the involvement of *ribā*. Stocks indices are also excluded due to their indulgence in excessive risk or *gharar*.

The discussion on the forward contract includes the forward commodity market, the possibility of trading gold on a forward basis and the forward market for currencies. An analogy has been drawn between the conventional forward contract and similar contracts in Islamic law such as *bay' al-salam*, *bay' al-istiṣnā'* and *bay' al-ṣifah*. The present study rebuts the claim that there is no benefit in the conventional forward contract or that it contradicts the principle enshrined in the *ḥadīth* "do not sell what is not with you". The possibility of trading gold on a forward basis is also discussed starting with a brief history of the world monetary system, followed by a critical analysis of several *fatwās* on the issue of gold trading and then expounds on the 'illah behind the prohibition of selling gold on deferred basis and its implications on trading gold on forward basis. No final conclusion has been upheld as the main objective of addressing this particular issue in this work is to invite more research on the issue due to its profound implications to Islamic finance as a whole.

Several alternatives to the forward currencies are explored and debated. Among the proposals advanced here are the concept of mutual promise (*muwā'adah*) which is a mutual promise of currency exchange at the spot rate of exchange. These alternatives also include the concept of mutual loan where an equivalent amount of money in different currencies is exchanged between the two parties as benevolent loan (*qarḍ ḥasan*) and the concept of a basket of currencies where the settlement of price between the importer and the exporter is made in several hard currencies. The final alternative is the idea of a cooperative fund whereby traders will participate by depositing a certain amount of money that will be managed by a third party in order to share the profit, if any, or face any risk associated with possible currency fluctuations.

My analysis of the futures contract addresses the main arguments against such a contract. I have elaborated on the concept of sale prior to taking possession, the sale of debt for debt, hedging and the relationship between speculation and margin trading and relevance, if any, of speculation to financial crisis. The present research has also examined the importance of the clearinghouse, the role of intermediaries in futures market and the regulation of the futures industry. Generally I have referred, in my discussion of these issues, to the Malaysian derivatives industry and its regulatory framework.

The efficacy of trading in options is accentuated by the need to avoid the problems associated with the forward and futures contracts. The present study proposes *khiyār al-sharṭ* and *bay' al-'arbūn* as tools of risk management and as possible alternatives to options. In this connection I have argued that option does not involve the combination of two contracts in one transaction. The present analysis also addresses the use of *'arbūn* in currency exchange, commodities, financial services, shares trading and *salam*.

The sale of pure rights, as it is in the case of options, is one of the hotly debated issues raised against the permissibility of options. The present study argues in favour of the sale of such rights relying on the general principles of Islamic commercial law and by referring to specific cases where a right is sold or exchanged for money. Included among the cases I have highlighted are the sale of the right of *shuf'ah* or preemption, the rights of easements or *ḥuqūq al-irtifāq*, the right of reservation over barren land (*tahjīr*), intellectual property right and the right of option in *khiyār al-sharṭ*. The present research also deals with the permissibility

of exchanging one's right to bargain for something; a woman waiving her right of *ḥadānah* or custody in exchange for something, or waiving one's right to recover one's gift in exchange for something. Finally, the present study raises the issue of involvement or otherwise of gambling in options and provides suitable response.

المقاصة ودور الوسطاء في أسواق المستقبلات والقوانين المنظمة لها، وقد اعتمدت الدراسة في هذا الجانب على قانون المشتقات المالية الماليزي وتوابعه.

إن أهمية الاختيارات في الأسواق المالية المعاصرة تنجم عن قدرتها لتفادي عيوب عقود تأجيل البدلين وعقود المستقبلات، وقد ناقشت الدراسة إمكانية تقديم خيار الشرط وبيع العريون كأدوات إسلامية للتحوط وكبديل للاختيارات. كما ناقشت الدراسة استخدام بيع العريون في الصرف والسلع والأسهم والخدمات.

إن بيع الحقوق المجردة كما هو الحال في عقود الاختيارات يعتبر أحد الأسس التي ارتكز عليها البعض لتحريم هذه العقود، وقد ذهبت الدراسة إلى جواز بيع مثل هذه الحقوق معتمدة في ذلك على القواعد العامة للمعاملات ودور العرف في تحديد نوع الحقوق التي يجوز بيعها، كما استعرضت الدراسة صور فردية أجاز فيها الفقهاء بيع الحقوق وتطبيق ذلك على بيع الحقوق في الاختيارات.

ومن أهم هذه الصور الفردية: بيع حق الملكية الفكرية وبيع خيار الشرط وبيع حق الشفعة، كما تعرضت الدراسة للتنازل عن حقوق الارتفاق والتججير وحق المساومة وحق الحضانة بمقابل مالي. كما تناولت الدراسة العلاقة بين عقود الاختيارات بالقمار وقدمت إجابة كافية.

ملخص البحث

إن أهمية المشتقات كأدوات مالية لإدارة المخاطر أمر مسلم به في الاقتصاد المعاصر، وقد دعا عدد من العلماء والباحثين إلى الاستخدام الحذر لهذه الأدوات في المعاملات الإسلامية، إلا أن هذه الأدوات وبصورتها الحالية لا تتفق تماماً مع القواعد المالية الإسلامية.

تبدأ الدراسة بنقد تحليلي للدراسات السابقة ثم تنتقل إلى دراسة كل من عقد تأجيل البدلين، عقود المستقبلات، وعقود الاختيارات من الناحية الشرعية. كما تتعرض الدراسات إلى الفوائد الاقتصادية لهذه العقود وطبيعتها القانونية مع تقديم البديل الإسلامي متى ما بدا ذلك ضرورياً.

تستخدم عقود المشتقات في أسواق السلع والأسهم والمعاملات والمؤشرات، وسعر الفائدة إلا أن نطاق هذا البحث يركز على استخدام هذه العقود في أسواق السلع والأسهم فقط. ويعود ذلك إلى أن استخدام هذه العقود في أسواق أسعار الفائدة والمعاملات من الربا الواضح الذي لا خلاف فيه. أما استخدامها في أسواق المؤشرات فيشتمل على غرر فاحش ولذا أخرج عن نطاق هذا البحث.

إن دراسة عقد تأجيل البدلين تشمل استخدامه في أسواق السلع وإمكانية بيع وشراء الذهب مع تأجيل البدلين والبديل لتأجيل البدلين في أسواق المعاملات. وهكذا فقد أجريت مقارنة بين كل من عقد السلم والاستصناع وبيع الصفة من جهة وعقد تأجيل البدلين من جهة أخرى، كما حاولت الدراسة دحض الزعم بأنه لا توجد أي فائدة من عقود تأجيل البدلين أو أنها تخالف مبدأ "لا تبع ما ليس عندك".

أما عن تأجيل البدلين في بيع وشراء الذهب فقد بدأت الدراسة بنبذة تاريخية موجزة عن النظام النقدي العالمي تلتها دراسة نقدية لعدد من الفتاوى عن تجارة الذهب ثم فصلت القول في العلة وراء منع الشارع لبيع وشراء الذهب مؤجلاً ومدى تأثير ذلك إذا فقد الذهب في العصر الحاضر تلك العلة. والغرض الأساسي من بحث هذه الجزئية هو استنهاض الهمم لمزيد من البحث حول هذه القضية نظراً لتأثيرها الكبير على نظام الصيرفة الإسلامية ككل.

أما عن البدائل لتأجيل في أسواق العملات فقد ناقشت الدراسة عدة مقترحات أهمها: المواعدة في الصرف، مبادلة القروض الحسنة ونظام سلة المعاملات وصيغة الصندوق التعاوني.

أما عن دراسة المستقبلات فقد تعرضت الدراسة بالنقد للحجج والأدلة المحرمة لهذه العقود، خاصة فيما يتعلق بعلاقة هذه العقود بالبيع قبل القبض وبيع الدين وعمليات التحوط والمضاربة وعلاقة ذلك بانهيار الأسواق المالية. كما تعرضت الدراسة لأهمية غرفة